1975

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Recommended Citation
Tempo, Vol. 21, no. 1 (1975), p. 18-20

# LIVING WITH INFLATION–BRAZILIAN STYLE

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Public accounting has been doubly caught by the dramatic increase in inflation in most industrialized countries. In addition to the economic impact on incomes and living standards, serious professional issues are raised. How, we are asking ourselves, can our clients' financial reporting be made more useful during an inflationary period, and how else can we help clients develop information for making economic decisions?

While inflation may not be here to stay at its current rate, it is hard to see how it will decrease rapidly or disappear entirely. We have been living with inflation for many years, tending to ignore it. It may be useful to take a look at how another country has made substantial economic progress during a highly inflationary period. Is there anything in its experience which could help those of us who are new to high rates of inflation?

Recently I lived in Brazil for two and a half years, and I found its "inflation survival kit" to be an interesting package with good ideas. This experience with economic decision-making and financial reporting in an environment of high inflation suggests new approaches to this worldwide problem.

I should emphasize that Brazil enjoyed record economic expansion during my time there—this was before the oil crisis—and that from the middle 1960s until 1973 the rate of inflation fell steadily as the economy continued to strengthen. It is too early to say what the full impact of the oil problem, renewed inflation, or a general world recession might be on Brazil, and whether the successes of the past can be repeated. But business and the man in the street did survive and thrive with inflation, which has been well over 20 percent in their period of growth; and their techniques for dealing with it are worth studying.

Unique conditions, of course, influence the approaches which can be taken to inflation. The recent growth of the Brazilian economy has been most notable in the industrial sector, although it is still a heavily agricultural nation. Furthermore, the government either controls or has the power to control prices and wages. Another aspect is that the government is not subject to being voted out of office. This means it can exercise its authority free from the self-interest lobbies which have a significant influence in many industrialized countries.

The government has helped to generate Brazil's growing economy through: (1) encouraging both foreign and domestic investments by means of tax and financial incentives, (2) honoring foreign capital and income repatriation policies, and (3) using natural and human resources effectively. Equally important are the government's monetary policies, and it is these that are the most interesting and relevant.

The totally demoralizing effect that inflation has on business and on individuals prompted the Brazilian government to develop a system of monetary correction—the idea being to protect investor's funds and personal savings from erosion. Essentially, monetary correction takes two forms: first, there is what I call "cash flow" monetary correction; secondly, there is an accounting adjustment for changes in the purchasing power of the cruzeiro—the local currency unit—with tax benefits.

### Cash Flow Monetary Correction

Cash flow is the key to survival in inflationary conditions, but one of the first effects of the recent high inflation in the USA has been the reduction of cash flow. In the industrialized economies, it is common for businesses and individuals to incur long-term debt at fixed interest rates. As inflation increases, however, terms become shorter and rates higher.

In Brazil, it is unusual to have domestic debt longer than two years. All long-term interest rates for domestic loans have some variable factor, called monetary correction, built in to adjust for the effects of inflation. The adjustment is usually based on the index the government uses to monetarily correct government bonds. Although borrowers may be uncomfortable with what are effectively flexible interest rates, they must also be realistic—for the gain to those who borrow at a low, long-term rate is a real loss to the lender during increased inflation. The result is that, eventually, lenders will not lend at these rates.

Monetary correction in Brazil is made not only to long-term liabilities but also to certain monetary assets. Brazilian government bonds are monetarily corrected for inflation, but instead of an extra variable interest, the redemption value of the bond is increased with inflation. This increase is another form of cash flow monetary correction. Also, individual savings accounts with banks attract interest plus a variable monetary correction. Furthermore, short-term savings are often put into commercial paper or on the "open market," the former traded by brokers, the latter with banks. Both attract interest rates which cover inflation; being short-term, the rates are usually fixed in advance.

The interesting part of this correction of monetary transactions is that it somewhat changes our thinking of financial management during inflation. For example, proponents of general price level accounting tell us that holding net monetary assets is not wise during inflationary times; general price level accounting results in a charge to income which represents a loss in purchasing power through holding net monetary assets—or, conversely, a credit to income for holding net monetary liabilities. But if monetary assets and liabilities are monetarily adjusted, as in Brazil, there may not be the necessity to incur debt and spend cash so fast.

Granted accounts receivable and payable are not adjusted except by agreement; in Brazil, these often roll over fairly quickly, as I will explain. The significant advantage of this form of monetary correction is that it does allow a company to maintain certain liquid monetary assets with some protection. This enables a company to use these cash resources as leverage when negotiating purchase terms, sales contracts, or financing. Brazilians are not pressured into putting their cash into non-monetary and less liquid assets because of inflation.

The need for both liquidity and a close control over cash flow during inflationary periods cannot be overemphasized. The normal checking account is not monetarily corrected in Brazil and has to be carefully watched. Trading transactions are recorded, not only on invoices but also on a document called a "duplicata," which is similar to a note and is often a copy of a sales invoice. These notes are often discounted with banks or pledged as security for loans on a roll-over basis, or simply deposited in a bank for collection. A copy goes to the customer, who settles directly with the bank. The discount rates vary with inflation rates, of course, and depend, as well, on the bank-customer relationship. But, this flexibility of short-term financing is a useful way of solving short-term cash flow problems, even if it may be expensive. Discounting receivables is not a new concept, but the automatic creation of a debt note for that purpose with every transaction is not used in all countries.

**An Accounting Adjustment With Tax Benefits**

The second form of monetary correction is the accounting technique used to adjust fixed assets in the books of a company. Accumulated depreciation is also adjusted, and the net amount is credited to a capital reserve. Ultimately, it is used to issue stock dividends. Monetary correction of cost is amortized as a charge to income. The idea is similar to a general price level restatement. The index used is published by the government.

The interesting part is not only that the books are adjusted but also that the additional depreciation is tax deductible. And this is not all. Another index is applied to a company's working capital to compute a reserve known as the reserve for maintenance of working capital. Such an amount is also tax deductible. This deduction, together with the additional depreciation on monetary correction, is a realistic approach by the taxing authorities in Brazil to the effects of inflation on earnings—or, rather, to the adverse economic effects of taxing inflation-sourced earnings. It also means that accountants do not have to resort to such techniques as LIFO, in order to shelter earnings from the tax man.

Although it is only indirectly related to inflation, one successful monetary technique used in Brazil is the crawling-peg devaluation system. The speculative element has been removed from exchange transactions by a systematic devaluation of the cruzeiro by a small amount every 45 days or so, depending on the currency exchange market.

This gives foreign lenders confidence in the currency exchange for repayments, and it also helps importers and exporters by removing the threat of a damaging exchange adjustment. There is little likelihood of a similar system being adopted in fully-developed economies, because such economies would not be tied to one currency, nor to either a predictable balance of payments or direction of exchange adjustment. Floating rates have been regarded as more practical in recent times for the major world currencies.

The Brazilians are adopting income tax collection procedures used in the USA. Tax collection has been a traditional problem in Latin America, as in many other countries. Much progress has been made in Brazil because, first, taxes have been used by the present government for projects that have visibly improved the country and the lives of its people, and secondly, the collection process is spread out over the year following assessment and is not monetarily corrected. This means the impact on the taxpayer is lessened. Starting in 1975, however, taxes are to be collected on a current basis. In my opinion, the government was wise to establish on a softer basis a core of taxable entities and people, leaving the firming-up until later.

**What Can We Learn?**

The differences between the economies of the industrialized world and of Brazil are so great that it is obviously not appropriate to pick up Brazilian economic policies and attempt their application elsewhere. But some of their ideas may have relevance if inflation is to be with us at an uncomfortably high rate for a significant period of time—and perhaps even if it subsides.

Can we learn anything from Brazil about financial reporting—or about economic decisions under inflationary conditions? There is little accounting theory in English textbooks that will support the accounting aspects of monetary correction used in Brazil. Even the Brazilians have had difficulty with the practical application of the system, passing recent legislation to modify it. But in one way or another, inflated earnings on the historical cost basis should be retained and secured within a business to maintain its economic structure. And, as happens in Brazil, these "inflated earnings" should not be taxed or distributed.

The generally recognized way of sheltering earnings from taxation in the USA is LIFO accounting for inventories. But LIFO does not provide for replacement costs, does not reflect current values in the balance sheet, and only shelters a portion of working capital. What if one wants to shelter the rest of working capital and the fixed assets? Until taxing authorities recognize bases of accounting other than the historical cost method, little, if anything, can be done from the tax standpoint.

Nevertheless, inflated earnings should not be distributed to shareholders. A basis for computing such earnings should be established, which will permit them to be set aside from distributable earnings in financial reports. An effective way of doing this would be to establish current values for opening and closing financial positions, thus obtaining real increases or decreases in value. This was brought home to me by a conference on inflation accounting held in Toronto, sponsored jointly by Touche Ross Canada and *The Financial Post* of Canada. It was an impressive gathering and included chief executive officers of about 50 of the top 100 industrial companies in Canada, as well as many other business and professional leaders. Responses to questionnaires indicated that 71 percent of all the companies represented at the conference favored current value accounting over price level adjusted financial statements.

For many companies, this would be difficult to implement immediately. A more practical and simpler approach would be to estimate replacement costs for all nonmonetary assets and to redraft financial reports on this basis. The results of this, plus a consideration of the impact that planned distributions to shareholders would have on future cash flow, should produce a more informed judgment when considering an appropriate dividend rate. Of course, any current value approach is necessarily more subjective, and will bring greater challenges to our profession in attesting to the reliability of financial statements, but this may prove to be a significant improvement over traditional financial reporting practices.

Another lesson we may learn from Brazil concerns the utilization of cash resources. It is not logical to regard a dollar in the bank—even on time deposit—as a secure asset, because the interest received does not cover the erosion in the value of the currency—especially after taxation. Furthermore, if inflation breeds uncertainty and the long-term financing market dries up, we will have to establish reliable forms of short-term financing and avoid the temporary cash squeeze that can cause a business to fail. Not being a banker, I would not want to delve into this area more deeply, but the current structure of interest rates for short-term bank deposits, and for mortgages and other long-term financing, does seem out of balance—offering insufficient shelter against inflation to individuals, to businesses, and to lenders.

During times of high inflation, the weaknesses of historical cost accounting become apparent. The sooner we move to something more logical, therefore, the better professional service we will be able to offer our clients.

However, even if the rate of inflation drops in 1975 and thereafter, is it likely to disappear? I think not. Therefore, I believe mechanisms should be permanently built into our financial reporting system, our tax system, and maybe into our banking system, that will enable profitable economic decisions to be made, based on better financial data. For what it comes down to is that if we cannot wipe out inflation, we must learn to live with it. We certainly cannot continue to ignore it.