The global problem of inflation and need for inflation adjusted-financial reporting

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Abstract

Research background: Inflation, a macroeconomic phenomenon, may lead to an inaccurate presentation of financial data included in the financial statements, which otherwise should present a relevant and reliable information on financial health of the company.
Purpose of the article: The purpose of the article is to point out the relevance and quality of data contained in the financial statements in the context of existence of inflationary pressure in the economy, and thus point out the importance of inflation accounting in the practice of business entities in the current situation (and not only in hyperinflation economics).
Methods: In accordance with the purpose and the theoretical nature of the article, there will be preferably used the method of analysis and comparison of existing literature, method of opinion confrontation, method of synthesis and generalization. The subject of the analysis will be principally scientific sources dating from the 70s of last century to the present and IAS 29.
Findings & Value added: The comprehensive elaboration of the issue in question from a theoretical point of view is a basic prerequisite for the carrying out the empirical research in conditions of Slovakia, pointing to its pros/cons and possible obstructions of its implementation in the process of financial reporting under current economic situation that except other is characterized by a general rise in the prices of economic goods, while inflationary pressures are currently being seen as a worldwide problem.

Keywords: *financial statements; inflation; inflation accounting*

JEL Classification: *M40; M41; F65*

1 Introduction

The primary objective of the financial statements, generally financial reporting respectively, is to provide reliable and relevant economic and financial information on economic entities. The information is useful and mostly importantly necessary for

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economic decision-making of shareholders, external providers of capital, business partners, state institutions including mainly tax authorities and rule makers, professional public, and other stakeholders in making investment or credit decisions, business decisions or other similar resource allocation decisions etc. Providing high quality and useful accounting information is a prerequisite for the efficiency of the company (Zamel et al., 2020) and all the company´s stakeholders (Kliestik et al., 2020; Svabova et al., 2020; Mazanec & Bartosova, 2021). However, it may be the case that, despite the effort to present a true and fair view of events that occur in the company, financial statements are unable to provide relevant information due to inflation if inflationary "pressures" are not reflected in the financial statement data. The accounting financial reporting regime is mostly nominal, which assumes no changes to the purchasing power of money over time (Zamel et al., 2020). Inflation, the systematic decrease in purchasing power and destroyer of wealth, is a rudimentary fact that creates serious financial reporting and financial management problems. If prices are unstable, financial reports can become extremely unsatisfactory and misleading (Bello, 2017) and thus using the right method of accounting is crucial for decision-making purposes of the company (Flynn, 1977 ; Mbambo et al., 2020; Ebiaghan, 2019).

If we consider the trend in price development today (mainly as the response to the global COVID-19 crisis), it is a similar situation as in the 70s of the 20. century, when the issue of inflation accounting came to the fore for the first time and began to be addressed by the professional public. The main challenge today is therefore whether the financial statements in economically developed countries should not "reflect" the inflation situation in the national economy, even though the rate of such inflation is not as significant as, for example, in hyperinflationary economies (as they are defined in the purpose of financial reporting according to US GAAP or IAS/IFRS.

2 Methodology

The aim of the paper is to follow up on the above fact and present a professional and relevant view of the issue. In the article, the author deals mainly with the justification of the existence of the institute of inflation accounting in relation to the basic mission of the financial statements – to provide relevant and truthful information about the financial and economic situation of a business entity. The article is by its nature a theoretical discussion of the issue of inflationary accounting. The key scientific methods applied in the process of preparing the paper are the method of analysis, the method of opinion confrontation, the method of abstraction and synthesis. The subject of the analysis are studies that deal with the subject matter and IAS/IFRS. The comprehensive elaboration of the issue in question from a theoretical point of view is a basic prerequisite for the carrying out the empirical research and the application of specific analytical methods in conditions of Slovakia, pointing to their pros and cons and possible obstructions of their implementation.

3 Inflation and relevance of financial statements

3.1 Inflation, the effect of inflation on business accounting

Inflation is a macroeconomic phenomenon that influences the behaviour and decisions of individual economic agents. This term e. g. Gregova (2015); Lisy et al. (2011); Falck et al. (2021) refer to a rise in the general price level caused by an imbalance between the trade needs and quantity of the money. Tamimi and Orban (2020) defines it as a situation in which the demands exceed the available goods and the real income flows. Economists

generally agree that in the long run, price inflation is related to increases in the money supply (Trichet, 2004). From an economic point of view, the most serious is hyperinflation, which is characteristic of the period of stagflation of the economy. Hyperinflation is a situation when the growth rate of product prices in the national economy raises faster than 50% per month, eventually 1,000% yearly that in general quickly erodes the real value of the national (local) currency (Frankel, 2010).

Inflation is perceived as one of the most serious economic problems today and a significant barrier to starting the economy in the context of the COVID-19 crisis. According to the portal Statista, in 2020, the global inflation rate amounted to approx. 3.2%, whereas economic estimates point to its continued growth for 2021 Statista (2021). In the long run, the worst situation is in Venezuela (2720%, data from May 2021), Sudan (388%, data from May 2021), and Lebanon (138%, data from May 2021). The growth rate of product prices in the range from 50% to 100% is in Syria, Suriname, Zimbabwe, and Argentina. In 18 countries, the inflation rate ranges between 10% to 30% (Trading Economics, 2021). Euro Area Statistics (2021) reports that inflation in the Euro area (expressed as HCPI) reached 3% in August 2021, while the worst situation is in Estonia, Lithuania (both 5%) and Belgium (4.7%). Overall, 9 countries within the Euro area have higher inflation rate than the average inflation rate in the Euro area including Slovakia (3.7%). If we consider the inflation target of the European Central Bank (symmetric 2% over medium term) European Central Bank (2021), the current growth in the price level is contrary to the target of the Bank.

Unacceptable inflation leads to the issuance of financial results in a misleading manner, and thus it causes difficulty in making any proper decisions. Financial reporting quality is the extent to which accounting information accurately reflects the current operating performance of the company, is useful in predicting future performance, and helps to assess firm value (Dechow & Schrand, 2004). According to IASB (2010), financial information included in the financial statements should be useful and should possess substantial qualitative characteristics, namely relevance, and reliability in the meaning of faithful presentation of financial data. Accounting as a social science, is affected logically by the environment in which it operates, while one of the most important factors that affect accounting system is inflation. In general, financial reporting is a function of the economic, legal, political, and social environment in which it operates and thereby any relevant changes in this environment create a need for persistent development of the accounting as the practical science (Zamel et al., 2020; Kliestik et al., 2020; Svabova et al., 2020; Mazanec & Bartosova, 2021).

During the disproportionate increase in the price level, it loses any significance to report financial data based on historical accounting approach (historical prices) that under the "normal" circumstances is objective and excludes the influence of subjectivity. Inflation has negative effects on the objectivity of accounting data and information, through a decrease in the purchasing power of the monetary unit of measurement, which shows the historical cost limitation in the evaluation, addressing that negative impact on the values of financial statements and financial reports in general (Tamimi & Orban, 2020). Inflation distorts all financial statements, but primary attention in the many public discussions is usually focused on the way how inflation affects reported incomes (Davidson & Weil, 1975). Cisko & Kliestik (2013) state that inflation gap in the financial reporting failures to point to the current worth of the company, inaccurately determines profit or loss of the company, misdirects in real values of certain items of financial statements, and depreciates the reproductive function of depreciation in relation to the creation of resources for the acquisition of new fixed assets. Divergence between replacement cost and accumulated depreciation due to price inflation becomes larger the less accelerated the depreciation formula is.

3.2 History of inflation accounting and approaches to inflation in accounting

Inflation accounting (price level accounting) generally refers to the process of adjusting the financial statements of the company to show its real financial picture during the inflationary period (Kirkman, 2014). According to Chea (2011), inflation accounting is an improved system of measurement which brings financial statements into harmony with current costs and values and provides a foundation for analysis of economic earnings and financial position of the company in an inflationary environment, including any special effect of inflation.

Any interest in inflation accounting has changed through time in direct relation to the inflation rate. According to e.g. Cisko, S., Kliestik (2013); Singh (2016) inflation accounting is an essential requirement for stability of business sector, overall market efficiency, and economic development due to its ability to reflect true and fair view of the operations of the company; its ability to ensure the comparability of accounting data between companies and across time; its ability to properly compensate the cost of production factors and maintaining reproduction capacity; its ability to get tax benefits by providing depreciation on replacement cost; its ability to report for gains and losses on holding monetary assets and monetary liabilities; its ability to improve the stability of accounting unit in general; its ability to correctly report corporate profit and loss, thereby to reflect true financial conditions of the company; its ability to improve corporate decision-making ability on future investments.

According to Whittington (1983); Hakki (1992) the beginnings of inflation accounting are dated in the 1900s, beginning with the index number theory and purchasing power, mainly in the USA and in the United Kingdom. The quantitative theory of money presented by Irwing Fisher, for example, was used by Sweeney (1936) in his book “Stabilized Accounting”, who developed the methodology of constant purchasing power accounting, later adopted by the American Institute of Certified Public Accountants in their study “Reporting the financial effects of price-level changes” in 1963. The same approach was later applied e.g., by the Accounting Principles Board (USA) in the Statement 3, after that by the Financial Accounting Standards Board (USA), its successor organization, in the financial accounting standard (FAS 33, Constant Dollar Accounting) and within Europe, by the Accounting Standards Steering Committee (UK). As for the newer period and the international scope, in 1987 International Accounting Standard Board presented the exposure draft E31 “Financial reporting in hyperinflationary economies”, which was issued in 1989 as IAS 29 with the effective date since 1990. The IAS 29 should be applied by any company from the beginning of the reporting period in which it identifies existence of hyperinflation in the country in whose currency reports its financial statements according to the list of factors that indicates that the economy is hyperinflationary (GrantThornton , 2020).

Inflation accounting includes a range of approaches designed to correct problems arising from historical cost accounting in the presence of high inflation and hyperinflation. In view of the varying degrees in which inflation affects different businesses and industries, and even different aspects of the same business or industry, the task is a complex one. Any difficulties are exacerbated by the fact that inflation itself is a variable from day to day, from commodity to commodity and frequently impacts upon the value of commodities in a manner which requires subjective evaluation outside the marketplace. This is also the reason of existing different approaches/methods to restatement accounting data in financial statements due to existing inflation pressures. Although there is no agreement among accounting professionals upon a unitary method to neutralize the effects of inflation, according to analysis of existing studies, accounting standards, and accounting principles, inflation accounting is based on two principal pillars – current purchasing power accounting method (CPP) and current cost accounting method (CC). However, between

these methods lie other various approaches being suggested by experts depending on specific circumstances, including generally accepted accounting principles at national level. In general, therefore, it should be true that the contribution of any approach to restatement the financial statements due to the growth of price level should be verified through empirical studies if these approaches are to be accepted as accounting principles (nationally or internationally).

According to Hakki (1992) the rationale for CPP approach to inflation adjustment in accounting is that it is the general value of money that is needed to be corrected for because the money value of any commodity in the accounts should reflect the general purchasing power embodied in that commodity, i.e., the approach maintains the general purchasing power of the invested capital. The approach ensures that current and prior-year financial statements would be comparable in terms of purchasing power and would be an important addition to the present financial statements prepared in accordance with the historical cost approach, which are presented in units of money of unequal purchasing power. According to Lee (2009) the aim of the approach is to determine the real changes in the well-being of the business and to exclude all effects resulting from the fluctuation in the value of money, which do not represent real changes in financial position of the company. Only non-monetary items in the accounts i.e., items, which do not carry fixed values are adjusted to inflation using the ratio of the price index at the end of the period and the price index at the date of transaction. Monetary items (e.g., cash, receivables, marketable debt securities, long-term or short-term debts, payables etc.) is not reasonable restated because they are already expressed in terms of the monetary unit at the end of accounting period. According to many studies the main advantage of this method is its relatively simple application and availability of information that are needed to restate chosen accounts; hence price indexes are objective and prepared and published on a regular base.

The CC accounting method restates both monetary and non-monetary items to their current values using the concept of appropriate values and valuation methods. Professionals mostly worked with the concept of realisable value, replacement cost value, economic value, or deprival value. Once the current costs (values) are obtained, financial statements can be produced by restating historical costs with these values. The CC accounting method is more efficient in comparison to the accounting approach based on historical data for all assets and expanses, since the decision usefulness of historical cost data declines, even if there are not any inflationary pressures. The main obstacle of the approach is however the fact that determination of some current cost cannot be done accurately due to technological changes and incomplete markets for certain assets. Moreover, it is impossible for a single and neutral agency, such as government, to provide current prices of numerous different items in the economy. Thereby this approach considers the price changes that are more relevant to company or industry rather than the economy i.e., the method fails to capture the effect of general price level increases while dealing with specific price changes (Hakki, 1992; Chambers 1977). Thus, on the other hand, the objectivity of CC accounting in comparison to the CPP accounting method is considerably lower.

The realisable value (exit value or fair value) is the value at which an asset could be sold at the current market in the current conditions According to Cisko & Kliestik (2013); Hakki (1992); Sedlakova et al. (2019) however objectively setting of the price of the asset on the market requires a complete market for that asset. In practise, hence complete markets do not exit for all assets, the valuation is based on hypothetical transactions and may incorporated subjectivity of the valuator. The replacement cost value is equal to the current buying prices of assets, which the company acquired in the past. The principle of this valuation generally is seen as the basis of current cost accounting approach. According to Friedman (1981), replacement costs are costs that are needed to acquire the productive capacity which would provide the current level of economic services i.e., the basis for

replacement cost is not the existing facilities, but the level of economic services provided by these facilities. However, for instance (Flynn, 1977) states although there are tendencies to estimate replacement cost value in a reasonable manner, the value is subjectively determined anyway, since the subjectivity is necessarily involved in making the estimates, and even more it is based on an unrealistic premise, i.e., the total replacement of all productive capacity at one time.

The economic value used withing this approach to reporting inflation in financial statements is derived generally from the use of the asset and calculated based on its net present value. According to the value of the use of the asset e.g., (Flynn, 1977) mainly points to the alternative use value of the asset i.e., the value of asset should be equal to the opportunity cost, the forgone benefits, that would have been obtained by an alternative use of the asset, "going concern value", or the value that is related to the earnings potential of the asset. Since the practical calculation of the present value (in generally) is regarded as too subjective in accounting practise (mainly in the case of non-monetary assets), accountants do not see this approach as a reliable basis for the inflationary restatement of financial statements for external reporting purposes (Friedman, 1981). The deprival value (value to the firm, value to the owner, or value to the business) is based on the premise that the value of the asset equals to the loss that the owner of the same asset would sustain if deprived of that asset. It is usually interpreted as implying measurement at replacement cost for the asset whose recoverable amount (the highest value obtainable from use or disposal) exceeds replacement cost (Zijl & Whittington, 2005). Based on this general premise, the deprival value is equalled to either the lower value of replacement cost or recoverable amount (value), while the recoverable amount is the higher of net selling price and value in use. Most of practitioners see this approach to be harder for practical use and its use may also lead to values significantly different from current market values. Also, the mutual comparison of the values of assets of different companies seems to be tough where deprival value is used because it reflects the position of the reporting entity (Horton et al., 2011).

4 IAS 29 "financial reporting in hyperinflationary economies"

International accounting standards/international financial reporting standards (IAS/IFRS) conceptually define the assumptions standardized financial reporting. Individual accounting standards are therefore focused on specific issues or the area that forms the substance of the financial statements. According to IAS 1 IAS "Presentation of financial statements", the general objective of the purpose of financial statements, along with other information in the disclosures, is to provide information about the financial position, financial performance, and cash flows of the company that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements should include information about the company´s assets, liabilities, equity, income, and expenses, including gains and losses, contributions by and distributions to owner, and cash flows. (IAS, 1.9) In some jurisdictions, the IAS/IFRSs are adopted in their entirety; in other jurisdictions the individual IAS/IFRS are amended or harmonized with the national general accounting standards. In some jurisdictions the requirements of a particular IAS/IFRS may not have been adopted. Consequently, users of the fact sheet in various jurisdictions should ascertain for themselves the relevance of the fact sheet to their particular jurisdiction.

IAS 29 "Financial reporting in hyperinflationary economies", including its interpretation IFRIC 7 "Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies" represents the standard of the methodology of financial reporting in economies that are under the pressure of hyperinflation, while the existence of the Standard is given by a logical assumption – "in a hyperinflationary economy, reporting of operating results and financial position in the local currency without

restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading". (IAS 29.2) IAS 29 had originally been issued by the International Accounting Standards Committee (IASC) in 1989 and become applicable for annual reporting periods commencing on or after 1 January 1990 in the countries that have adopted IAS/IFRS standards.

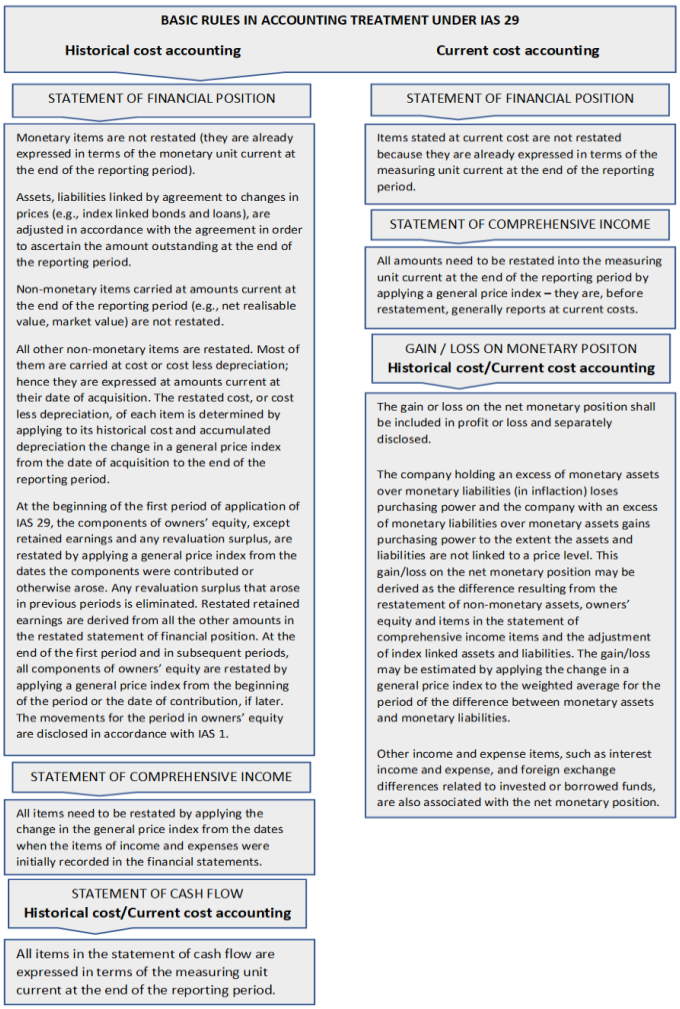

Fig. 1. Basic rules in accounting treatment under IAS 29.

Source: own processing

The IAS applies to the financial statement of the company from the beginning of the reporting period in which the company identifies the risk of hyperinflation in the national economy in whose currency it prepares the financial statements (IAS 29.4), whether it uses a historical cost approach, or a current cost approach in financial reporting. The rate of hyperinflation is not directly set in the IAS 29 it is a matter of judgement when restatement of financial statements in accordance with the Standard becomes necessary. (IAS 29.2) One of the factors of hyperinflation listed in the IAS 29 is the cumulative inflation rate that shall approach or exceed 100%. (IAS 29.3 (e)) Other factors are rather of the qualitative nature and in general point to a loss of confidence in the domestic currency. However, when the

company stops adjusting financial statements to inflation pressures due to the national economy ceases to be hyperinflationary, it shall treat the amounts expressed in the measuring unit current at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements.

According to Center of Audit Quality (2021), an independent institution which except other is being interested in monitoring countries all over the word due to their identification as inflationary economies for the purposes of applying US GAAP (those criteria for identifying such countries are similar to those for identifying hyperinflationary economies under IAS 29), there are currently (May 2021) seven countries with three-year cumulative inflation rates exceeding 100% (Argentina, Iran, Lebanon, South Sudan, Sudan, Venezuela, and Zimbabwe). Except them, there is a country with projected three-year cumulative inflation rates greater than 100% in the current year (Suriname), and countries with projected three-year cumulative inflation rates between 70% and 100% or with a significant (25% or more) increase in inflation during the current period (Angola, Haiti, Liberia, and Yemen).

From the theoretical point of view, the IAS 29 bases on the approach of CPP accounting method (IAS 29.37) and therefore its principles, too. I.e., financial information included in the financial statements are being restated by applying a general price index with the requirement of the consistent application of these principles and judgements from period to period. Applying IAS 29 may result in the creation of additional temporary differences under IAS 12 Income Taxes, because the restatement of item under IAS 29 will often lead to adjustments to the carrying amounts of items without corresponding changes to their tax bases. The effect of such temporary differences will need to be recognised in profit or loss under IAS 12. (IAS 29.32)

From the analysis of the wording of the IAS 29, including its interpretation IFRIC 7, it is obvious, that restatement of individual items of financial statements depends on the accounting approach that the company applies under the "normal circumstances". The reporting treatment is depicted in the Fig. 1.

5 Discussion and conclusion

The current economic situation is characterized by an effort to "restart" the national economies of individual countries of the world, despite the still present COVID-19 crisis. Its effects result, among other things, in a rising rate of inflation, which is currently a phenomenon occurring in national economies, regardless of their degree of development. As for, e.g., Slovakia or other countries that are part of the European Monetary Union, the current rate of inflation "goes beyond" the inflation target of the European Central Bank. At the micro level, inflation also has a clear impact on the quality of data presented in the financial statements of a business sector, if we are talking mainly about inflation, which is the character of an economically unacceptable rate of growth in the price level. An analysis of existing studies clearly shows that any interest in inflation accounting has changed through time in direct relation to the inflation rate. In such situation, inflation accounting is an essential requirement for stability of business sector, overall market efficiency, and economic development mainly due to its ability to reflect true and fair view of operations of the company and its ability to ensure the comparability of accounting data between companies and across time.

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