Exploring the Effects of Inflation on Financial Statements through Ratio Analysis

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Abstract

The article explores the effects of inflation on financial statements. Inflation, even at lower rates affects financial statements. International Accounting Standard 29 "Financial Reporting in Hyperinflationary Economies-IAS 29" imposes some percentage criteria as to the restatement of financial statements. This criteria-an inflation rate for restatement of financial statements can be set as minimum as possible, because inflation adjustments change the figures even at lower inflation rates. As the inflation accelerates the effects of inflation become more apparent on financial statements. A model company has been developed and gradual increases in inflation rates have been tried on the model. Model shows that even at lower rates, the inflation negatively affects financial statements. Model shows what ratios are affected by inflation adjustments. Article proposes that inflation adjustments to financial statement should be a continuous issue and should be consistently applied to financial statements even at lower rates than required by IAS 29.

Key words: Inflation, inflation effect, inflation effect on financial statements, monetary losses, monetary gains, financial ratios**.**

1. Introduction

Inflation has affected many economies for many years. It was a continued issue in 1980s and International Accounting Standards Board (IASB) has put IAS 29 in effect "Financial Reporting in Hyperinflationary Economies-IAS 29" as of January 1, 1990. As it is stipulated in the IAS 29 standard, financial statements need to be restated-cleared from the effects of inflation, if the last three years` cumulative inflation rate in an economy is approaching or exceeding 100%. In the years after 2000 the tendency of inflation has eased down but with the hike of recent petroleum price increases, inflation again is becoming an issue especially in developing and underdeveloped countries. I think Zimbabwe`s last three years cumulative inflation rate of 9,340% could be an example in this respect. A model company developed for this article portrays the results of gradual increase of inflation rates on income statement and balance sheet. The model allows us to compare non-restated (unadjusted for inflation) income statement and balance sheet figures with restated ones. Considering both local and foreign companies operating in an inflationary environment, inflation adjustments affect all balance sheets no matter the origin of the company. Reporting to the parent is an issue for the foreign companies operating in an inflationary environment. Reporting is the other face of the coin as it depends on the movement of devaluations or appreciations of the local country`s currency against the reporting currency. This article deals with only the inflation effect on the financial statements and its economic repercussions for the companies in an inflationary environment. The conversion problem of the subsidiaries operating in inflationary economies is not the subject of this article. The model company may operate in any country where there is an inflation. The name of the country is a secondary issue since the inflation problem is global and may even affect the G7`s economies.

2. Literature review

The objective of IAS 29 is to establish specific standards for enterprises reporting in the currency of a hyperinflationary economy, so that the financial information provided is meaningful.

In accordance with IAS 29 the requirements for restatement of financial statements are as follows:

1. The basic principle in IAS 29 is that the financial statements of an entity that reports in the currency of a hyperinflationary economy should be stated in terms of the measuring unit current at the balance sheet date. Comparative figures for prior period(s) should be restated into the same current measuring unit.

2. Restatements are made by applying a general price index. Items such as monetary items that are already stated at the measuring unit at the balance sheet date are not restated. Other items are restated based on the change in the general price index between the date those items were acquired or incurred and the balance sheet date.
3. A gain or loss on the net monetary position is included in net income. It should be disclosed separately.
4. The restated amount of a non-monetary item is reduced, in accordance with appropriate IFRSs (International Financial Reporting Standards), when it exceeds its recoverable amount.
5. The Standard does not establish an absolute rate at which hyperinflation is deemed to arise - but allows judgement as to when restatement of financial statements becomes necessary. Characteristics of the economic environment of a country which indicate the existence of hyperinflation include:
   - the general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power;
   - the general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency;
   - sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short; and
   - the cumulative inflation rate over three years approaches, or exceeds, 100%.
6. IAS 29 describes characteristics that may indicate that an economy is hyperinflationary. However, it concludes that it is a matter of judgement when restatement of financial statements becomes necessary (http://www.iasplus.com/standard/ias29.htm).

There has been a meeting held on November 20, 2007 between International Practices Task Force (IPTF-which is a task force of the SEC-Securities and Exchange Commission of USA staff and Regulations Committee). The subject of the meeting was about "monitoring inflation in certain countries".

At the March 2003 meeting of the Task Force, it was noted that it would be helpful to be more proactive in assessing the inflationary status of countries. As a result, it was agreed that a mechanism be developed for proactively monitoring the inflationary status of countries. The approach used was as follows:

The Task Force agreed to regularly consider the inflationary status of a number of countries for the purpose of determining whether they were highly inflationary as defined in FASB Statement 52-Counterpart Standard of IAS 29 in USA. It was agreed that inflation rates be monitored regularly (monthly to the extent possible) in order to identify cases where the Task Force could discuss a country's inflationary status. Based on the cumulative inflation information, countries would be categorized as follows:

1. Countries that are clearly highly inflationary (i.e., that have cumulative inflation approaching or exceeding 100%).
2. Countries with increasing cumulative inflation rates that should be monitored.
3. Countries that are clearly not highly inflationary (i.e., with sufficiently low cumulative inflation).

As understood from the Discussion Document-D of the meeting. Approaching or exceeding a 100% cumulative (last three years) inflation rate for an economy is a sign of its being in "highly inflationary" status. A ratio between 70-100% has been noted as to be highly inflationary. Paper also implies that countries with 70% or less cumulative inflation rates should be in close watch if their recent inflation trends are on rise. And thirdly countries having 70% or less cumulative inflation rates and having their inflation trends on decline would be considered as "not highly inflationary." Discussion paper also concludes that the following countries should be considered highly inflationary through December 31, 2007: Myanmar, Zimbabwe, Angola and Dominican Republic-came off this status starting from January 1, 2008, 2007 respectively.

Countries on the highly inflationary "watch list." The following countries are on the Task Force's inflation "watch list": Eritrea. Guinea, Haiti, Venezuela, Iran, Zambia (Discussion Document-D – November 20, 2007 Joint Meeting of International Practices Task Force (IPTF) and SEC Staff).

OECD-Organization for Economic Co-operation and Development has also been concerned for high inflations as it is explained on its report published in August 2003.

Most countries have suffered from inflation within recent memory and countries in Latin America and the former Soviet Union have lived with very high rates of inflation for several years. Under inflation, national accounts at current as well as at constant prices will be seriously distorted unless special adjustment techniques are applied. By explaining these in a systematic fashion, the author-OECD brings new insights into the definition and measurement of income as well as the calculation and interpretation of price indices (OECD Organisation for Economic Co-operation and Development, Inflation Accounting A Manual on National Accounting Under Conditions of High Inflation ,August 2003).

3. About the model

In order to reflect my thoughts regarding the affects of inflation on a company`s balance sheet and income statement (both statements may also be referred as financial statements or financials) A model company has been developed. The following is the flow of events and the assumptions that the company goes through:

- It is located in an inflationary economy. I.e. Turkey could be an example where the country has been through high inflation rates in the past. For example 2001 wholesale price index was 88.5%. Turkey has long struggled with inflation. For many years, inflation has destroyed income distribution and created an economy that does not use economic activity as a basis for growth, but has encouraged the rich to invest in government bonds rather than to increase production (.....).
- It is set up at January 31 of the year with a capital paid in cash.
- It makes two local purchases for resale and buys one machinery.
- It sells domestic customers without exports and imports as exchange rate fluctuations may hinder the full reflection of inflation effects on financials.
- Each transaction is assumed to have occurred at month ends.
- Adjustment entries like depreciation and calculation of cost of goods sold have been made at December 31, year end.
- The model is first run at 0% inflation rate then the rate has been increased at quarter of a percent per month.
- Monetary and non monetary items have been identified in order to adjust the company`s balance sheet and income statement with the inflation. I.e. monetary items represent the items that their purchasing power diminishes with inflation, like cash, accounts receivable, accounts payable, Government Services Tax (GST, this tax is an equivalent of VAT-Value Added Tax as it is called in Turkey) payable or receivable. Non monetary items represent the items that their purchasing power keeps pace with the inflation, like machinery, accumulated depreciation, inventory, paid up capital, sales, cost of goods sold-COGS and other income and expense items.
- Model company`s non monetary assets are adjusted (restated) with a multiplier-inflation index reflecting the realized inflation as at December 31 year end.
- Model is able to produce local currency financial statements, both with and without inflation effect.
- Model ignores income tax calculation, its accrual and payment due to the reason that tax calculation may differ from company to company even though the tax rate is the same across the economy. In order to keep the model simple the net income referred here represents income before tax.
- Figures in the model company are denominated in $ a currency indicator only-no matter what nationality the dollar has.

However, since taxation policy lies at the root of the argument for introducing inflation accounting methods, unless there is ultimately some modification to the present method of calculating taxable profits that will take account of the effect of the depreciating purchasing power of money, then much of the value of Government approval is lost. In the final analysis, the aim of inflation accounting must be to conserve cash resources to provide for the replacement of plant, machinery and other physical assets and until it is accepted that the state will have to accept a reduced share of trading profits by way of taxation, and so leave the vital cash in the business, then all the academic arguments about the respective virtues of this or that system of inflation accounting are little more than verbal shadow-boxing (Goch, 1976).

4. Findings

Table 1 on the following page shows the effects of inflation on financial statements as the model company is run from 0% inflation on monthly basis (corresponding to 0% inflation on annual basis) to 2% monthly inflation (corresponding to 26.82% annual inflation) with increments of 0.25% per month:

Inflation at 0 rate means no inflation and the company is incurring a profit of $10,750, working capital ratio (current assets divided by current liabilities) of 4.3, quick ratio (current assets with the exclusion of inventory divided by current liabilities) of 4.1, debt equity ratio (total liabilities divided by equity) of 19%, total liabilities to assets ratio (total liabilities divided by total assets) of 16%, sales return ratio (net income divided by sales) of 28.7%, gross margin ratio (gross profit divided by sales) of 49.3%, asset profitability ratio (net income divided by assets) of 8.2%, inventory turnover ratio (cost of goods sold divided by inventory) of 6.3 times per year, and asset turnover ratio (sales divided by assets) of 0.3 times per year. This situation represents that the company is making a healthy profit and it is not under any severe debt burden as most of its assets are financed by the equity and the company is rich of current assets-liquid assets as its working capital ratio and quick ratio figures are greater than 4.

When the company starts applying inflation accounting rules, the following figures tend to change: Sales starts increasing as every month`s sale is restated (brought to the purchasing power) at December 31, and likewise all income statement items like COGS are restated to the purchasing power at December 31. Total assets and equity show an increasing trend as it covers non monetary items like inventory and fixed assets, paid up capital which are restated to the purchasing power at December 31. Current assets slightly increase because of inventory being a non monetary asset. If we look at the ratios, those ratios derived from monetary assets and liabilities show no change as they do not include any non monetary asset or liability. Working capital ratio increases slightly due to inclusion of inventory on the nominator. Quick ratio does not change throughout the inflation range as it excludes non monetary assets and liabilities.

Affects of Inflation on Financial Statements and Ratios

Monthly inflation rate %	0.0	0.25	0.50	0.75	1.00	1.25	1.50	1.75	2.00
Yearly inflation rate %	0.0	3.04	6.17	9.38	12.68	16.08	19.56	23.14	26.82
Current Assets	89,410	89,471	89,532	89,595	89,659	89,723	89,789	89,857	89,925
Current Liabilities	20,910	20,910	20,910	20,910	20,910	20,910	20,910	20,910	20,910
Sales	37,500	38,070	38,648	39,233	39,826	40,426	41,035	41,651	42,276
Net income	10,750	8,792	6,780	4,713	2,590	409	-1,831	-4,132	-6,495
Equity	110,750	111,571	112,420	113,280	114,157	115,051	115,964	116,894	117,843
Gross margin	18,500	18,636	18,770	18,902	19,034	19,163	19,291	19,417	19,541
Total Liabilities	20,910	20,910	20,910	20,910	20,910	20,910	20,910	20,910	20,910
Inventory	3,000	3,061	3,122	3,185	3,249	3,313	3,379	3,447	3,515
COGS	19,000	19,434	19,878	20,330	20,792	21,263	21,744	22,234	22,735
Total Assets	131,660	132,481	133,330	134,190	135,067	135,961	136,874	137,804	138,753
Working Capital Ratio	4.28	4.28	4.28	4.28	4.29	4.29	4.29	4.30	4.30
Quick Ratio	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Debt / Equity Ratio	0.19	0.19	0.19	0.18	0.18	0.18	0.18	0.18	0.18
Total Liabilities / Total Assets	0.16	0.16	0.16	0.16	0.15	0.15	0.15	0.15	0.15
Sales Return Ratio %	28.7	23.1	17.5	12.0	6.5	1.0	-4.5	-9.9	-15.4
Gross Margin Ratio %	49.3	49.0	48.6	48.2	47.8	47.4	47.0	46.6	46.2
Net Income / Assets %	8.2	6.6	5.1	3.5	1.9	0.3	-1.3	-3.0	-4.7
Inventory Turnover Ratio	6.3	6.3	6.4	6.4	6.4	6.4	6.4	6.5	6.5
Asset Turnover	0.28	0.29	0.29	0.29	0.29	0.30	0.30	0.30	0.30

Table 1

Debt equity ratio slightly decreases as its denominator (equity) gets higher due to restatement of capital and net profit which is also a result of restated income and expense items whereas liabilities do not include any non monetary item (in real world some non current-long term liabilities may include items like termination benefits which are of nonmonetary character). Total liability total assets ratio shows a slight decrease as the nominator of the ratio has no non monetary item but assets have inventory and fixed assets in it.

Turnover ratios do not show dramatic changes. Inventory turnover shows only a slight increase throughout the inflation range as both nominator and denominator of the ratio are of non monetary character (both are restated) and likewise the asset turnover ratio which shows a slight increase on the inflation range.

Profitability ratios on the other hand show dramatic changes. Sales return ratio starts with 28.7% profitability when inflation is zero and goes to minus 15.4% at 2% monthly inflation rate. Gross margin percentage drops by more than 3% despite the fact that both its nominator and denominator are of non monetary character. Net income over assets ratio goes from 8.2% positive to 4.7% negative on the inflation scale. Any ratio with net income figure shows a dramatic decrease. The reason is that inflation sweeps away the profits. This model company is in liquid position as its quick ratio shows and inflation negatively affect its liquid assets namely accounts receivable and cash. Both accounts receivable and cash being non inflation resistant items, lose their purchasing power more and more as inflation accelerates. It may be argued that some of these assets can be invested in interest or dividend earning investments like bank deposits and shares. Though both type of investments can protect the company against inflation, it has limits, a company can not invest all its cash to time deposits because it has to have some cash for immediate needs and accounts receivable can be factored but it has a cost which normally reflect the market`s prevailing borrowing rates and what is more, it would not make any sense to factor the accounts receivable while the company has no any cash problem. Besides interest earned increases the company`s tax base. It can further be argued that this cash can be converted to the expansion of the business or for acquisitions. They are both valuable and valid arguments but investment decisions of this type are of long term nature and requires commitment whereas inflation reflects itself on our daily lives.

Michael K. Salemi, in his article named "Hyperinflation" says that "In effect, inflation is a form of taxation in which the government gains at the expense of those who hold money while its value is declining." Gerald Feldman's book named " The Great Disorder" shows a photo of a small firm transporting wages in a wheelbarrow because the number of banknotes required to pay workers grew very large during the hyperinflation (Feldman 1993). Corbis, an Internet source of photos (www.corbis.com), shows an image of a German woman burning banknotes in her stove because doing so provided more heat than using them to buy other fuel would have done. Another image shows German children playing with blocks of banknotes in the street.

More recent examples of very high inflation have occurred mostly in Latin America and former Eastern Bloc Nations. Argentina, Bolivia, Brazil, Chile, Peru, and Uruguay together experienced an average annual inflation rate of 121 percent between 1970 and 1987. In Bolivia, prices increased by 12,000 percent in 1985. In Peru, a near hyperinflation occurred in 1988 as prices rose by about 2,000 percent for the year, or by 30 percent per month" (http://www.econlib.org/library/Enc/Hyperinflation.html.)

Inflation hides the facts on financial statements. In the model company example, if company does not adjust its records to show the effects of inflation which is considered to be hyperinflationary being 2% per month which converts to $(1+0.268)^3$ a little more than 100% on three years cumulative basis. According to IAS 29 requirements it is time to start restating the financials but what if the inflation is running at lower rates than 2% a month, no requirement as its three year cumulative rate stays under 100% according to the current stipulation. Here the assumption made ignores the other signs of hyperinflation like people investing their money rather that keeping it idle like buying more refrigerators, automobiles or gold or time deposits which earns interest more than the inflation but these behaviours are normal and expected as people naturally become aware of the sweeping effects of inflation on their purchasing power.

5. What are the Inflationary Trends over the World?

Inflation is an ongoing phenomenon all over the world not only in old Eastern Bloc or
South American Continent countries as it was in 1970s and 1980s. The Table 2 below has been obtained from http://www.indexmundi.com which shows CIA World Factbook as its source:

Consumer Price Indexes from Different Countries around the World

	CONSUMER PRICE INDEX INFLATION RATE %			LAST THREE YEARS CUMULATIVE INDEX %
	2005	2006	2007	
Afghanistan	10.3	16.3	13.0	45.0
Angola	18.5	12.2	11.8	48.7
Bangladesh	6.0	7.0	7.2	21.6
Brasil	7.6	6.9	3.0	18.5
Bulgaria	5.0	6.5	7.8	20.5
Cambodia	3.1	5.8	5.0	14.5
Canada	1.9	2.2	2.0	6.2
China	4.1	1.8	1.5	7.6
Eritrea	10.0	15.0	14.0	44.2
India	4.2	4.2	5.3	14.3
Iran	13.5	15.8	17.0	53.8
Kenya	7.6	15.6	12.0	39.3
Myanmar	3.8	10.7	26.3	45.2
Pakistan	4.8	9.1	7.9	23.4
Romania	9.6	9.0	6.8	27.6
Syria	2.1	5.0	8.0	15.8
Turkey	9.3	8.2	9.8	29.9
Turkmenistan	9.0	10.5	11.0	33.7
U.S.A.	2.5	3.2	2.5	8.4
United Arab Emirates	10.5	10.0	12.0	36.1
Venezuela	22.4	16.0	15.8	64.4
Zimbabwe	133.0	276.4	976.4	9,340.2

Table 2

Table 2 shows that inflation is still a concern for some countries on the world. I.e. Zimbabwe has more than 9 thousands percent cumulative inflation rate in last three years until December 31, 2007. Compared to our model company (which has 26.82% annual inflation rate at the highest) any company who has good liquidity but operating in a hyperinflationary country like Zimbabwe would have even more severe effects of inflation on its financials. As far as other countries are concerned what would be the best cumulative 3 years` rate to start applying IAS 29 rules? That`s the critical question to be answered. In order to give a clear answer to this question further analysis are needed. Table 3 below brings the relationship between monetary losses, net monetary position, net income, assets and inflation rates, net monetary position (NMP) into the picture:

Relationship between Net Monetary Position, Net Income and Assets

Monthly inflation rate %	0.0	0.25	0.50	0.75	1.00	1.25	1.50	1.75	2.00
Yearly inflation rate %	0.0	3.04	6.17	9.38	12.68	16.08	19.56	23.14	26.82
Monetary loss	0	1,723	3,492	5,306	7,168	9,078	11,037	13,047	15,109
Net Monetary Position	65,500	65,500	65,500	65,500	65,500	65,500	65,500	65,500	65,500
Monetary loss / Net Mon. Pos.	0.00	0.03	0.05	0.08	0.11	0.14	0.17	0.20	0.23
Net Monetary Pos. / Assets	0.50	0.49	0.49	0.49	0.48	0.48	0.48	0.48	0.47
Net income	10,750	8,792	6,780	4,713	2,590	409	- 1,831	- 4,132	- 6,495

Table 3

Net monetary position is the difference between monetary assets minus monetary liabilities. In the model company this is explained with the following formula. NMP = ((Bank + Acct. Receiv. + GST Receiv) – (Accts. Payab. + GST Pay.)). As it is observed from the above Table 3, this figure is the same throughout the inflation range (since monetary assets and liabilities are not subject to restatement).

The ratio of monetary position to assets is around 50% despite the fact that inventory and fixed assets are restated. Being NMP is the same over the inflation range, the more the inflation is (either per month or per year) the greater the monetary losses are. It can be inferred that for a company who is cash rich (as it is the case for our model company) the lower the inflation rate for restatement the better the company`s financials will be to show its true financial position net of the inflation effects. Referring back to Table 2, Canada as an example, has the lowest 3 years cumulative inflation rate of 6.2%. Comparing that figure on Table 3 on the 6.17% of annual inflation rate, it can be said that even a company being cash rich and operating in Canada where the inflation is very low can lose its profits due to inflation after three years (net income of $10,750 at 0 inflation rate versus net income of $6,780 at 6.17% inflation rate on Table 3 which corresponds to 37% loss on net income).

NMP as it conveyed above had a difficulty of definition, at least among some authors in U.S.A. In the United States, the first statement issued by FASB that set the standard for reporting the effects of inflation on business enterprises was Statement of Financial Accounting Standards No. 33 (FAS33), Financial Reporting and Changing Prices, in 1979. FAS33 required certain companies to disclose supplementary information on both a current cost basis and on a constant dollar basis. However, it was felt that the guidelines were not sufficiently focused so that the disclosure of supplemental information would have become standard. One of the main areas of concern was the determination of net assets. There appeared to be many interpretations of FAS33 on the measurement of net asset amounts after the effects of changing prices have been taken into account (Yang, Miklos, Vasarhelyi, Caixing, Shima, 2005).

It is not only U.S.A., adopting the IFRS-International Financial Standards. Many countries struggle in the alignment and reconciliation of their own GAAP to international standards. In China, the financial reporting principles used by some companies may differ from IFRS standards adopted by the PRC. This paper has addressed some of the differences between U.S. GAAP and PRC-Chinaese GAAP. However, since accounting principles are industry-specific, it is important for Chinese companies entering the U.S. market to obtain an analysis of the accounting differences from a recognized professional accounting firm that has experience in both the home market and the U.S. market. Firms that are capable of providing that service include KPMG, PriceWaterhouse Coopers, LehmanBrown, and Deloitte among others (Munoz, Chamblin, Zheng-Pratt, 2008).

6. Remedies

What remedies could be considered for cash rich companies who are operating in inflationary environments in order to alleviate the negative effects of the inflation on their financials? From the data presented above the following remedies can be considered:

1. Keeping the net monetary position as low as possible. It can be referred from Table 3 that more inflation rates leads to more monetary losses at having a net monetary position over asset ratio of 50%. In fact no company wants to keep its cash idle. But here the point is, not only the cash, it is the net monetary position. That means keeping monetary asset minus monetary liabilities position as small as possible. It could be done either minimizing accounts receivable and maximizing accounts payable and keeping the cash as invested in interest or dividend bearing investments, buying inventories, fixed assets or making acquisitions. If purchasing power losses are made by holding monetary assets there must obviously be the possibility of a gain where an individual or an organisation is in debt. This is probably the most controversial aspect of current inflation accounting proposals. The principles involved can once again be explained with the aid of a bank finance situation—Brown borrowed £1,000 from the bank on 1st January 1974, and repaid the amount involved on 31st December 1974. In these circumstances Brown will probably have made a gain as the purchasing power of the £1,000 repaid at the end of 1974 will not have the same purchasing power as the amount originally borrowed on 1st January 1974. In 1974 the gain in this situation was approximately £190—the retail prices index rose by over 19%—but there would be interest charges to set against this gain. After allowing for tax deductions it is extremely unlikely, however, that the net interest charge will be in excess of 19 %, and as a result the borrower will have made a net gain in purchasing power terms, although this does not alter the fact that a significant amount will have to be paid out in interest charges (Kirkman, 1975).

2. Start to calculate the effects of the monetary losses on the financials even though it is not required according to IAS 29. Monetary losses can still be calculated over the net monetary position (even on a monthly basis on balance sheets) and an adjustment can be made to the income statement for internal reporting purposes (as there is no restriction on calculating the monetary loss for internal-managerial accounting purposes).

Companies should not anticipate the IAS 29 rules or local rules to change in the short run as there is an increase in inflation level in the economy. It is due to the fact that declaration or implementation of such rules have also political repercussions. Having said that there is no reason why public companies can not put a shed of light in their annual reports as an explanatory note regarding the effects of inflation to inform the users of financials about what is going on behind the formal reporting. There appears to be an inexplicable death wish among users of financial statements to be conned by artificially high profit figures. Many of them know that HCA figures are a curious and misleading mixture of operating profits and holding gains but they show no desire to be informed about the real state of affairs of a company after taking into account the effects of inflation. As in many other facets of life appearance is infinitely more attractive for the investor than reality (Lothian, 1978).

In the case of general price-level accounting, experimentation by individual companies is but a part of the economic impact analysis—it is only the micro consideration. Government and industry will not stand mute in the face of proposals carrying potentially great economic implications for their spheres of activity, particularly when no economic studies are at hand which analyse the probable consequences of the accountants' handiwork. Even in the presence of such studies, political opposition may be expected. If the accounting profession lacks political power, it can at least raise the likelihood that the ensuing struggle will have some basis in rational economic analysis (Zeff, 1976).

3. Educate the personnel regarding the effects of time value of money and inflation. If the company is cash rich there might be other advantages to consider at procurement, i.e. getting more than inflation rate discounts from suppliers or paying suppliers earlier with a more than inflation rate of discount on invoices. Keeping the idle money invested or paid as dividend according to cash flow projections.

7. Conclusion

Inflation can have hazardous effects on financial statements. It is an uncontrollable external factor for management. It can be dealt with, as it`s been tried to be explained above, management is advised to watch the inflation and calculate the possible effects of it on the financials. If the company is a subsidiary operating in an inflationary environment outside Canada where the parent resides, the situation can be even said more delicate if the country of operation is an inflationary one. The country of operation may have inflation rates lower than 100% on three years cumulative basis and the local laws and IAS 29 rules may not require the companies to restate their financials. If IAS 29 does not require it, there is nothing to be done for formal reporting for consolidation purposes. In situations like this there are other options for reporting, like applying IAS 21 “The Effects of Changes in Foreign Exchange Rates.” If inflation and devaluation rates are running in parallel then applying IAS 21 will still lead to proper reporting just like the application of IAS 29 on local currency basis. Here the procedure will be as such that every transaction will be converted to the currency of reporting (CAD for a Canadian subsidiary) and again the monetary losses (or gains) will be calculated at reporting periods over the monetary balance sheet items.

If inflation and devaluation are not running in parallel then the situation gets a bit more complicated. In such a case there might be some overstatement or understatement issues since financials are not adjusted (restated) for the inflation effects in the first place. Application of inflation restatement solves the problem to a considerable extent even though the inflation and devaluation do not run in parallel because any loss or gain due to inflation will have been recognized in the income statement even devaluation is lagging behind the inflation or it is just the opposite. The company might be a local one or a subsidiary, whether its shares are traded in the stock exchange or not, in all situations companies are under the effect of inflation. The degree of effect can change from company to company based on its net monetary position. I think it is better to measure the effects of inflation-even it`s low than never.

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