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FINANCIAL REPORTING FACULTY

HOW HIGH INFLATION IMPACTS ACCOUNTING

GUIDE

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As inflation increases after a sustained period of low inflation, companies are now having to consider the impact high inflation has on their financial reporting and related uncertainties.

Although the effects of high inflation will vary from business to business, there are some common topics that entities should evaluate when considering how recent inflationary trends may affect their accounting and financial reporting. This guidance looks at those considerations that may be relevant when inflation is high as opposed to it being considered hyperinflation. Amongst other indicators, hyperinflation is typically where inflation measures 100% or more cumulatively over 3 years. When inflation becomes hyperinflation, IFRS reporters should apply IAS 29 *Financial Reporting in Hyperinflationary Economies*. Those reporting under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* must apply Section 31 *Hyperinflation*.

Inflation is the rising of prices over time and the decrease in the purchasing value of money. As such, inflation impacts the time value of money. When inflation is negligible, it is not necessarily a factor that requires significant judgement or estimation. However, as it increases more care may need to be taken.

While there may not be a specific standard to account for inflation, the impact on financial statements can be widespread. There are several financial reporting areas affected by high inflation, including discount rates used to reflect the time value of money, forecasting and going concern assessments, as well as sufficient disclosure explaining unusual movements, estimates and judgements.

CONDITIONS AT THE BALANCE SHEET DATE

A fundamental principle to keep in mind throughout the preparation of financial statements is that they should reflect conditions that existed at the balance sheet date. The macroeconomic environment can evolve rapidly. Care should be taken by management to distinguish between information that reflects conditions at the balance sheet date and subsequent conditions.

Information which comes to light after the balance sheet date that provides evidence of conditions that existed at the balance sheet date (adjusting post-balance sheet events) should be reflected in amounts recognised in the accounts. Information indicative of conditions that arose after the balance sheet date (non-adjusting post balance sheet events) should be disclosed when material.

Read more on:

- How to distinguish adjusting from non-adjusting post balance sheet events under UK GAAP
- How to distinguish adjusting from non-adjusting events after the reporting period under IAS 10

FORECASTS

Inflation, supply chain constraints, and labour shortages all affect a business's forecasts. Forecasts are used in a variety of accounting estimates, including, but not limited to, those relating to the assessment of:

- goodwill or other long-life assets for impairment;
- certain provisions, such as rehabilitation provisions
- estimates of future taxable profits related to the recovery of deferred tax asset balances; and
- going concern.

In developing forecasts and assessing the related accounting implications, businesses should consider whether the effects of the uncertainties are short-term or long-term and how that determination will affect various accounting estimates.

With the exception of going concern assessments (see below), the estimated future cash flows must be based on conditions that existed at the balance sheet date, taking into account expectations as at that date about possible variations in the amount or timing of those future cash flows.

It may be appropriate to adjust cash flow forecasts, including those prepared to assess going concern, to incorporate funds available under government support schemes.

JUDGEMENTS AND ESTIMATES

In periods of high inflation, preparation of accounts may involve more significant judgements and sources of estimation uncertainty. Specific disclosure requirements are triggered where there is significant risk of material adjustment to the carrying amounts of assets or liabilities within the next year. To ensure users are provided with information relevant to their understanding of the financial statements, longer-term uncertainties falling outside those specific requirements may also merit disclosure. For example, in the areas of going concern assessment and fair value measurement.

Where inflation assumptions represent a source of significant estimation uncertainty entities will need to explain how the inflation assumptions have been calculated and disclose appropriate sensitivity.

Explanations should also be provided for any changes to past assumptions where the uncertainty remains unresolved.

Read the article: Judgements and estimates: improvement noted, but more needed

DISCOUNTING

Reflecting the time value of money by discounting is a core concept of finance and accounting. Several accounting standards permit or require entities to measure assets or liabilities by discounting estimates of future cash flows to their present value.

Measurements of present value require two main sets of inputs: future cash flows (which may require the amount, timing and other uncertainties thereof to be estimated); and discount rates (to convert those cash flows to an equivalent amount of cash held at the measurement date).

Consistency of inputs

Determining an appropriate discount rate is already a complex area of financial reporting, and one which can be a source of significant estimation uncertainty in itself. As it increases, the rate of inflation may become an input that requires additional significant judgement or estimation compared to the recent past.

The inputs into a present value calculation can be either before, or after inflation. Nominal cash flows, which include the effect of inflation, should be discounted at a nominal rate. Real cash flows, which are net of inflation, should be discounted at a real rate.

Where given the option, the decision on how to include inflation in present value calculations is usually based on whether the nominal cash flows and nominal discount rate can be measured more reliably than the real cash flows and real discount rate. The most important thing, however, is that assumptions in the estimates of future cash flows and the discount rate should be consistent (ie, either both in nominal or both in real terms). Providing the inputs are consistent, the resulting measurement is the same.

Multiple discount rates

Often, a single rate is used to discount all the cash flows being discounted. This is the case in value in use calculations and provisions for example. A single discount rate will generally give an appropriate result where cash flows are relatively evenly spread over time and the market has a stable outlook; the single rate can be thought of as a form of average of the spot rates for different maturities.

However, where cash flows are not spread evenly over time, or will be received or paid at a distinct point in time, it may be necessary to use spot rates that are matched to the maturity profile of the cashflows. The same is true when the estimated discount rate is not expected to be constant over time. For example, low or negative interest rates in the short-term may only have a limited impact on the measurement of long-term assets and liabilities.

Effect of discounting?

When future cash flows will occur within a year or less, the effect of discounting is often considered negligible. However, as well as considering the period of time, this assessment must also consider the prevailing interest rates in the relevant market as they are often a proxy for a deterioration in purchasing power. In periods of high inflation therefore, the effect of discounting over shorter periods may not be considered negligible.

Read the article: Improvement needed on discount rates disclosures, FRC warns

VALUATION RELEVANCE AND CONSISTENCY

When estimating the value of assets and liabilities, valuation techniques and their inputs generally remain consistent from period to period. However, as the market conditions in which entities operate evolve and inflation increases, entities may need to consider whether valuation techniques and related inputs are still appropriate and provide relevant values.

INFLATIONARY CLAUSES IN CONTRACTS

As the effect of higher inflation becomes more significant, entities should pay close attention to contractual clauses linked to inflation and consider any financial reporting impact.

When entering into revenue, leasing, supply or financing contractual arrangements that include inflationary clauses, consideration may need to be given to the existence of embedded derivatives and the impact, if any, on the financial statements. The following information should be considered and disclosed:

- the nature of inflationary features;
- accounting policy adopted for such features;
- significant judgements made by management; and
- the potential effect of such features on the financial statements.

Inflationary features may be particularly prevalent in leasing contracts. Disclosures to explain the extent of such features, including the key variables and magnitude of variable lease payments relative to fixed payments, may be required.

RENEGOTIATIONS AND MODIFICATIONS

Concerns about inflation may cause a business to revise its strategies and enter into new or different transactions. Where an entity's business model and operations are affected, there are likely to be consequential impacts on its accounting and financial reporting.

High inflation may result in the renegotiation of long-term contracts, such as leases, loans or supply agreements. The accounting implications of contract changes require careful consideration. For example, depending on the nature of a debt refinancing it may be reported as a modification or an extinguishment of the original financial instrument. This could also have consequences for loan covenant disclosures.

The timing of any contract renegotiations should also be kept in mind. The effective date of any such renegotiations or refinancing impacts which reporting period it relates to. If the renegotiation occurs after the balance sheet date, it will need to be considered whether it is an adjusting or non-adjusting event.

Read more on:

- IFRS 16 Leases FAQs
- Modifications to revenue recognition under IFRS 15
- Contract modifications under IFRS 9 Financial Instruments
- Renegotiating loan contracts under FRS 102

Listen to a webinar on Contract modifications under IFRS

IMPAIRMENT REVIEWS

Impairment reviews involve various judgements and estimates, including those related to future cash flows and discount rates.

Impairment reviews of financial assets such as trade debtors, contract assets or lease receivables, will require consideration of macroeconomic variables. As well as inflation levels, these could include GDP growth and unemployment levels.

Impairment reviews of non-financial assets such as goodwill or other intangibles, may include a weighted average cost of capital (WACC) calculation. High inflation might impact the WACC, which in turn feeds into the discount rate used in the impairment review.

Read the factsheet Applying IAS 36 *Impairment of Assets*

Read the factsheet FRS 102 Impairment

DEFINED BENEFIT PENSION SCHEMES

The net defined benefit (DB) pension liability or asset (deficit or surplus) is calculated as the present value of the DB obligation less the fair value of any plan assets.

When estimating the obligations of a DB pension scheme, actuaries use multiple assumptions. These will incorporate factors such as the retail price and consumer price indices, as well as other factors impacted by inflation such as salaries, benefits and medical costs. Entities should monitor the appropriateness of the assumptions and discount rate(s) used by the actuary to measure any pension-related liabilities and assets. Due to increases in salaries and other costs, a larger obligation may be calculated in periods of high inflation.

Inflation will also impact the yield curves used by an entity to determine the discount rate used to measure the present value of the DB obligation. With higher inflation, higher yields may lead to a higher discount rate and so a reduction in present value, potentially counteracting other increases in the obligation.

The techniques and assumptions used to fair value plan assets will also need to be carefully reviewed for relevance and appropriateness. Periods of rising prices may result in an increase in fair values.

Depending on the extent to which each component increases or decreases, it is possible that DB pension schemes may move from a deficit to a surplus in a period of high inflation. Where this is the case, the extent to which any surplus can be recognised will require consideration. A surplus may only be recognised to the extent that it is recoverable either through reduced contributions in the future or through refunds from the plan.

ONEROUS CONTRACTS

In periods of high inflation, businesses may not fully pass on cost increases to their customers. Consequently, existing contracts may become loss-making resulting in the need to assess whether a provision for an onerous contract is required.

INVESTMENTS

As businesses review their investment strategies in the light of higher inflation, they may consider making different types of investments or moving away from holding excess cash on hand. Businesses may choose for example, to invest in gold as a hedge against inflation. Entities contemplating such changes should consider carefully the associated financial reporting implications.

Companies should clearly explain their investment strategy and associated risks.

HEDGING ARRANGEMENTS

Businesses may enter into more complex or material hedging arrangements to mitigate risks to cash flows from the effects of increased inflation, and the assessment of these may require the use of specialists.

Where hedge accounting is applied, higher inflation and greater volatility in the market may impact the economic relationship or create additional ineffectiveness within existing hedging relationships. Careful monitoring and assessment of hedging criteria and effectiveness will be necessary.

Read the factsheet IFRS 9 *Financial Instruments* – hedge accounting – Updated

NEGATIVE DISCOUNT RATES

Even in times of high inflation, it is possible that the real discount rate is negative. Negative discount rates result in the future value of an asset being less than its present value and vice versa for a liability.

Accounting standards do not impose limits when determining a discount rate in the event the risk-free rate turns zero or negative. However, when this is the case, an entity may need to consider the impact on the financial statements, including presentation and additional disclosure. To illustrate:

- The offsetting of income and expenses is prohibited unless required or permitted by a specific standard. When a negative interest rate results in an expense being recognised on a financial asset, it should not be presented as a reduction within interest income but instead be presented in a separate non-interest expense classification.
- A provision is measured at present value by discounting the expected expenditure to settle the obligation. The discount rate used reflects the time value of money and risks specific to the liability. If the discount rate is a negative rate, the carrying value of the provision will be greater than the expected future cash outflow.

GOING CONCERN ASSESSMENT

When preparing financial statements, management must evaluate the entity’s ability to continue as a going concern. In assessing going concern, all available information about the future, being at least 12 months from the end of the reporting period, must be considered. Where material uncertainties exist that cast significant doubt upon the company’s ability to continue as a going concern, those uncertainties must be disclosed.

When businesses are not prepared for high levels of inflation, the effects may cast doubt on their long-term viability and going concern status.

The way in which inflation interacts with an entity's budgeting will vary. In some cases, it might be appropriate to simply overlay an existing budget with a percentage increase. In others, there may be specific elements that are expected to change at a different rate to general inflation.

Variable interest rates might lead to increased debt repayments, putting a strain on an entity's cash flow. Extra focus should be placed on covenants for an increased risk that these may be breached. Whether the classification of liabilities between current and non-current remains appropriate should also be considered.

Parent companies may be required to provide greater support to struggling group entities, as well as facing similar issues themselves. It is important to ensure that any group support or guarantees can be delivered.

In all scenarios, disclosure of going concern assessments should be specific and sufficiently detailed.

Find out more at the Evaluating going concern hub

Read the guides:

- Going concern considerations – a guide for FRS 102 preparers
- Going concern considerations - a guide for IFRS reporters

INTERCOMPANY TRANSACTIONS AND GROUP RECONSTRUCTIONS

In a high inflation environment, more emphasis may be placed on intercompany transactions and group reconstructions. Before entering into such transactions, care should be taken to understand both the accounting and legal implications plus related complexities. For example, intercompany transactions at non-market terms can result in adjustments to equity which may bring distributable reserve considerations into play.

Aspects of the accounting for group reconstructions are subject to the requirements of company law (including share premium, distributable profits, and merger reserves). Therefore, the interaction between the legal requirements and the applicable accounting requirements (which differ between IFRS and FRS 102) will need to be carefully considered.

Read factsheets on:

- Interest in Other Entities
- Debt for Equity Swaps
- FRS 102 Debt for equity swaps
- UK Distributable Profits

Read more on:

- Loans at non-market rates under FRS 102
- Guidance on realised and distributable profits under the Companies Act 2006 (TECH 02/17 BL)

DISCLOSURES

To be useful, disclosures should be balanced, proportionate and sufficiently entity specific. With respect to inflation, better disclosures will explain how the effect of inflation was reflected and accounted for in cash flows and discount rates.

Additional disclosure providing context for the financial reporting areas most affected may be useful to users. For example, disclosures of sensitivities and downside scenarios that appear more severe due to the increased uncertainty or a change in the significant inputs.

In addition to disclosures in the notes to the financial statements, it is important to also consider information within the strategic report. The impact of high inflation on the principal risks and uncertainties faced by the entity should be considered and, where appropriate, details of how management is responding.

Disclosure of alternative performance measures (APMs) used should generally be presented consistently year-on-year. Any changes to definitions and/or calculations of APMs (for example, inflation-adjusted measures) should be adequately explained as to why they provide reliable and more relevant information.

Consistency of disclosures and information between the ‘front half’ and ‘back half’ of the annual report must also be ensured.

Read the factsheet Strategic Report and Directors' Report
Read the article Improving reporting to meet investors' needs

SUMMARY

The macroeconomic environment is continually evolving, and care should be taken by management to ensure that the most up-to-date information and estimates are embedded into budgets and forecasts, and in going concern assessments.

Throughout all affected areas, as well as the impact on measurement, consideration should be given to whether disclosure is required to improve the quality of financial information being reported.

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