

ANNUAL FINANCIAL STATEMENTS OF ECONOMIC ENTITY - ADJUSTED FOR THE EFFECTS OF INFLATION?

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Abstract

Inflation is a phenomenon of self-sustaining growth in the overall level of prices affecting the economy of a state with strong implications at both economic and social level. Inflation is eroding effect while the main purchasing power of money and the sustained growth of prices in the economy.

Prices change over time as a result of various economic and social factors, individuals or generals. Private factors, such as changes in supply and demand or technology, can generate significant price increases or decreases, independent of each other. In addition to the general factors may cause a change in the general level of prices and thereby the general purchasing power of the currency.

Key-Words: *inflation, annual financial statements, pricing, historical cost, money supply.*

JEL Classification: *M40, M41*

1. Inflation: definition, forms, ways of expression

Inflation is a reality of the contemporary world that affect both developed countries and the poor, impact on the company, the state and the individual.

The literature can be found a number of definitions of inflation, stemming from the fact that this phenomenon is considered "*one of the most controversial and complex economy*". [11]

Milton Friedman, the monetarist theory father, said that "*inflation is a currency disease, showing the direct symptoms of rise of prices*". [9]

Romanian economist Costin Kirițescu defines inflation as "*a meal cash exceeding the needs of economically, which means weakening the purchasing power of money*". [6]

Another definition of inflation is given by Cecilia Iliescu, who said that "*the phenomenon is an imbalance that occurs at some point between money (higher) and table goods and services (less). Escalating prices indicates monetary depreciation*". [6]

According to Nicolae Feleagă, synthetic definition given by G. Olive inflation can be summarized as follows:

increase in the general price level (and not slumping few products);

a self-sustaining phenomenon of rising prices and not an isolated phenomenon and accidental;

a price increase based on macroeconomic mechanisms (putting at stake the interdependence between all parties and all economic mechanisms: distribution, pricing, distribution systems, etc.)

Source: taken after Feleagă N., *Financial Accounting*, vol IV, Economic Publishing House, 1993, Bucharest, p. 16.

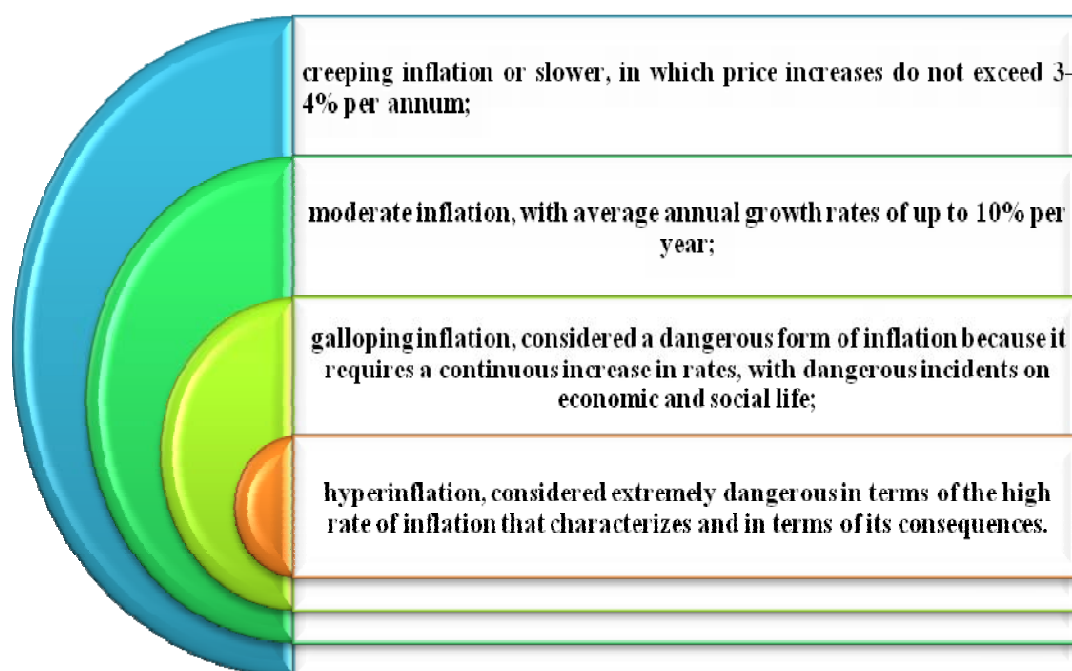
Figure 1 Definition synthetic inflation

According to Victor Jinga, inflation should be seen not only in monetary terms, as a consequence of the changes only monetary, but as a complex economic phenomenon that is "*not just the result of spacing between the total volume of goods and services and the overall currency; it is closely related to structural changes in supply and demand, whose changes would bump chief economic life*". [7]

If we define inflation through an increase in general prices, then we must note that, in fact, we are faced with an increase dispersed them. Some of them might be able to remain stable for a certain period of time, others even decrease. Overall, however, we are dealing with a general rise in prices. Therefore, any inflationary process is by definition heterogeneous.

Also, not every price increase necessarily mean inflation. To talk of such a phenomenon should we find ourselves before a dynamic process, ie before a movement that proves to be lasting. Once reached a certain level of prices does not necessarily mean that we are facing a damaging inflationary process.

Trying to appreciate inflation depending on the size or intensity of it, distinguish several forms, shown schematically in **Figure 2**.



Source: own processing

Figure 2. Defining inflation in the size and intensity

In conclusion, we define inflation as a complex economic phenomenon, emerged as a result of imbalances in the economic system and whose symptoms consist of chronic relevant and alarming increase in the budget deficit in goods and services rising prices and falling incomes in real ie its population buying power.

2. Adjusting the annual financial statements with the effects of inflation

In the event of any significant changes in purchasing power, the financial statements have not been adjusted for inflation may prove inadequate. From one year to another, amounts in the financial statements are not comparable, and the gain or loss resulting from changes in purchasing power are taken into account.

In conclusion, the financial statements adjusted for inflation does not accurately reflect the economic entity's financial position at the balance sheet date or her performance.

As shown in accounting standards Intrernațională, namely the International Accounting Standard 15 "in most countries, financial statements are prepared on the historical cost basis, without taking account of changes in the general price level or individual change in asset prices defined excluding fixed assets that were revalued". [13]

The active elements, equity, liabilities, income and expenses are expressed in terms of value on the date on which these elements have emerged. The impact of inflation is therefore ignored.

The annual financial statements are restated taking into account the effects of changing prices or in relation to changing the general purchasing power with the help of the general price index, according to International Accounting Standard 29 - Financial reporting in hyperinflationary economies, are using cost as the basis of assessment taking account of individual price changes of assets under IAS 15 - Information reflecting the effects of price changes.

"The financial statements adjusted for inflation represents an extension and not a violation of accounting principles based on historical cost method". [13]

The phenomenon distorts inflationary accounting information presented by the financial statements of the company in two ways:

- diminishes its equity;
- overstate results of the exercise.

Coupled with historical cost accounting and accounting application of a fundamental principle of the principle of prudence, inflation leads to lower equity value of the economic entity.

This principle provides an asymmetric treatment and plus minus-values - values which may affect the value of an asset or debt.

The reductions of value (minus-values) relative to historical costs should be recorded when they occur as probable by creating a provision for impairment, designed to reduce the value of a good or a debt to its real value. Conversely, increases in value compared with historical costs are not recorded before being carried out.

According to Alexander Țugui "if it were possible to extend recording in accounting for differences in inventory in addition to assets minus liabilities respectively, then it is merely a concrete application of a method adapted for inflation based evaluation". [12]

We believe that inflation leads besides diminishing net assets of economic value, and result in a distortion of the light effect year-synchronization that occurs between income and expenses are expressed in different currency units.

3. Conclusions

In our opinion, the decrease in value of the net assets of the economic entity and earnings overstatement are the main shortcomings of the application of the historical cost accounting under inflation, and their existence necessitate adjustment of the annual financial statements.

In conclusion, the precautionary principle whose application is trying to avoid overstating earnings and thus preserve the confidence of current and future shareholders that the results are not overstated and, also, to avoid fictitious dividend distribution, most often leads to systematic underestimation net assets of the economic entity.

ACKNOWLEDGEMENT

This paper has been financially supported within the project entitled "Horizon 2020 -Doctoral and Postdoctoral Studies: Promoting the National Interest through Excellence, Competitiveness and Responsibility in the Field of Romanian Fundamental and Applied Scientific Research", contract number POSDRU/159/1.5/S/140106. This project is co-financed by European Social Fund through Sectorial Operational Programme for Human Resources Development 2007-2013. Investing in people!

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