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How inflation could affect your financial statements

Business owners and investors are understandably concerned about skyrocketing inflation. Over the last year, consumer prices have increased 8.3%, according to the latest data from the U.S. Bureau of Labor Statistics. The Consumer Price Index (CPI) covers the prices of food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. This was a slightly smaller increase than the 8.5% figure for the period ending in March, which was the highest 12-month increase since December 1981.

Meanwhile, the producer price index (PPI) is up 11% over last year. This was a smaller increase than the 11.2% figure for the period ending in March, which was the largest increase on record for wholesale inflation. PPI gauges inflation before it hits consumers.

Key impacts

For your business, inflation may increase direct costs and lower customer demand for discretionary goods and services. This leads to lower profits — unless you're able to pass cost increases on to customers. However, the possible effects aren't limited to your gross margin. Here are seven other aspects of your financial statements that might be impacted by today's high rate of inflation.

1. **Inventory.** Under U.S. Generally Accepted Accounting Principles (GAAP), inventory is measured at the lower of 1) cost and 2) market value or net realizable value. Methods that companies use to determine inventory cost include average cost, first-in, first-out (FIFO), and last-in, first-out (LIFO). The method you choose affects profits and the company's ending inventory valuation. There also might be trickle-down effects on a company's tax obligations.

2. **Goodwill.** When estimating the fair value of acquired goodwill, companies that use GAAP are supposed to apply consistent valuation techniques from period to period. However, the assumptions underlying fair value estimates may need to be revised as inflation increases. For instance, market participants typically use higher discount rates during inflationary periods and might expect revised cash flows due to rising expenditures, changes in customer behaviors and modified product pricing.

3. **Investments.** Inflation can lead to volatility in the public markets. Changes in the market values of a company's investments can result in realized or unrealized gains or losses, which ultimately impact deferred tax assets and liabilities under GAAP. Concerns about inflation may also cause a company to revise its investment strategy, which may require new methods of accounting or special disclosures in the financial statement footnotes.

4. **Foreign currency.** Inflation can affect foreign exchange rates. As exchange rates fluctuate, companies that accept, hold and convert foreign currencies need to ensure they're capturing the correct rate at the appropriate point in time.

5. **Debts.** If your company has variable-rate loans, interest costs may increase as the Federal Reserve raises interest rates to counter inflation. The Fed already raised its target federal funds rate by 0.5% in May and is expected to increase rates further over the course of 2022. Some businesses might decide to convert variable-rate loans into fixed-rate loans or apply for additional credit now to lock in fixed-rate loans before the next rate hike. Others may restructure their debt. Depending on the nature of a restructuring, it may be reported as a troubled debt restructuring, a modification or an extinguishment of the debt under GAAP.

6. **Overhead expenses.** Long-term lease agreements may contain escalation clauses tied to CPI or other inflationary measures that will lead to increased lease payments. Likewise, vendors and professional service providers may increase their prices during times of inflation to preserve their own profits.

7. **Going concern disclosures.** Each reporting period, management must evaluate whether there's substantial doubt about the company's ability to continue as a going concern. Substantial doubt exists if it's probable that the entity will be unable to meet obligations as they become due within 12 months of the financial statement issuance date. Soaring rates of inflation can be the downfall of companies that are unprepared to counter the effects, causing doubt about their long-term viability.

We can help

Inflation can have far-reaching effects on a company's financial statements. Contact us for help anticipating how inflation is likely to affect your company's financials and brainstorming ways to manage inflationary risks.