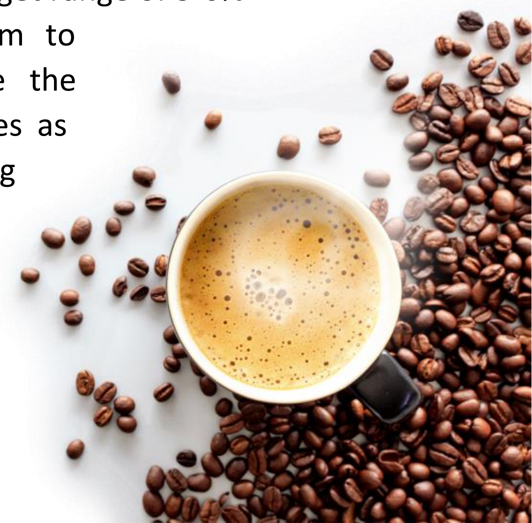
Inflation rearing its ugly head? Maybe it's all the fault of the Ever Given

In March 2021, the Suez Canal was blocked for six days after the grounding of the Ever Given, a 400-metre long, 20 000 TEU (Twenty-foot Equivalent Unit – a measure of container sizes) container ship, one of the largest in the world. This event led to the 6-day closure of the Suez Canal and the delay of several hundred other ships that were queueing to use the same thoroughfare, preventing an estimated nearly US$10 billion worth of trade. When the Ever Given was finally freed, it was impounded by the Egyptian authorities until July when a formal settlement on compensation to the Egyptian government was reached between its owners, its insurers and the canal operating authorities.

You may ask – what has all this got to do with inflation. Well, it would seem that this event as well as many other events of the last two years with the COVID-19-inflicted pandemic may have precipitated the position that we find ourselves faced with. The impact of the grounding of the Ever Given affected the supply and free flow of goods and the world is still to recover from it. Towards the tail-end of 2021, we saw the cost of shipping increase substantially worldwide. This coupled with bottlenecks in the supply chains created earlier in the year by the disruption in movement of goods has led to the shortages and prices of goods increasing at a rapid pace. And then there is the oil price which recently hit $90 a barrel, the first time that it has been at this level since October 2014 and up from below $20 a barrel in 2020 at the onset of the COVID-19 pandemic. The tensions between Russia, Ukraine and the NATO countries will possibly only serve to exacerbate this price.

The news at the moment is replete with announcements of rates of inflation in various jurisdictions in the world at levels that have not been seen in decades. The United States which has been the bell weather for economic growth and health recently reported its inflation at 7% (in January 2022) and the Federal Reserve is currently at increasing interest rates to help bring inflation under control to the 2% level that that economy has become accustomed to. Even Japan, which had been experiencing deflation and near zero inflation for many years is reporting a rise in its inflation rate to 0.5%. Germany and the United Kingdom are similarly afflicted with rates of 5.2% and 5.4%, up from an average of 0.5% and 2.5% respectively. South Africa is currently reporting inflation at 6% which is at the top end of its target range of 3-6% that the country's authorities aim to achieve and will most likely be the catalyst for increased interest rates as the central bank endeavours to bring the rate at which prices rise under control.



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The International Monetary Fund, in their literature, define inflation as "the rate of increase in prices over a given period of time. Inflation is typically a broad measure, such as the overall increase in prices or the increase in the cost of living in a country." While the inflation rates that I mention above will be of immediate concern to residents and corporate citizens in the jurisdictions affected, the levels are still manageable for the most part, with governments and regulators able to implement measures that will assist in controlling such inflation. At these levels, such economies are still seen to be relatively stable. In contrast, several economies around the world are currently considered to be experiencing severe inflation which is referred to as hyperinflation. As at November 2021, the Center for Audit Quality[1] (CAQ) SEC Regulations Committee and its International Practices Task Force, which accumulate and discuss inflation data from across the world, published a document which identified fourteen countries as being in hyperinflation, facing imminent hyperinflation or displaying signs of being in hyperinflation despite there being no official data to demonstrate this assertion[2]. While the CAQ has no official standing in making such pronouncements on the hyperinflation status of jurisdictions, their publications are persuasive as the information that they are based on is derived mainly from the IMF World Economic Outlook Report Database. It is still up to each jurisdiction to determine if indeed its economy is experiencing hyperinflation and for an authority within that jurisdiction to determine what steps should be taken from a financial reporting point of view and from when such steps should be implemented.

While there is no absolute rate at which hyperinflation is deemed to occur, there are certain indicators which one can use in applying their judgement in making such a determination, among them being:

- The general population in the country prefers to keep its wealth in non-monetary assets;
- The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. One may find that prices will be generally quoted in terms of that currency or if quoted in a local currency, the quote is valid for a limited period of time.
- Sales and purchases on credit take place at prices that compensate for expected loss of purchasing power during the credit period, even if the period is short;
- Interest rates, wages and prices are linked to a price index; and
- The cumulative inflation rate over three years is approaching or exceeds 100%.

The increase in the general level of prices that I mentioned results in a situation where the reporting of results from operations, the entity's financial position and cash flows generated or expended become less and less meaningful for the users of financial information that is prepared by issuers operating in hyperinflationary economies. The quickening of the rate at which money loses its purchasing power inevitably leads to a situation where it is not possible to compare transactions that occur at different times in the same financial year, let alone transactions that occur in different financial reporting periods. The solution that IFRS provides in respect of this is the application of IAS 29 *Financial reporting in hyperinflationary economies*. This standard requires the restatement of the amounts reported in order for such information to be decision useful.

IAS 29 requires the application of judgement as to whether or not an economy is in hyperinflation, taking into consideration the indicators provided earlier. The standard goes on to recommend that

[1] The Center for Audit Quality is an autonomous non-partisan, non-profit public policy advocacy organisation that is based in the United States of America and is affiliated with the American Institute of CPAs.

[2] caq_IPTF-November-2021-Inflation-Document_2022-01.pdf (thecaq.org)

should a jurisdiction find itself in hyperinflation, all entities that report in its currency should apply IAS 29 from the same date. Practically, an entity that operates in such a jurisdiction and uses the currency of that jurisdiction will apply the standard from the beginning of the reporting period in which it identifies the existence of hyperinflation.

Simply put, the application of IAS 29 entails the restatement of transactions that took place such that those transactions are stated in a unit of measure that is current as at the reporting date. As such, whether the issuer uses historic cost accounting or current cost accounting, there will be similarities in the approach taken in order to restate the financial information in a unit that the reader will understand at the reporting date under consideration.

IAS 29 requires the identification of indices that will be used to restate the amounts reported. There is no prescription as to the basis for such indices and one could premise the factors applied on consumer price (inflation) indices, exchange rates, or some other measure that may be in place in their jurisdiction that is used to determine the movement in the general purchasing power of the currency.

Time-value of money and its impact on interest earned or expended in any given period will be a concept that we are familiar with. Hyperinflation is a similar concept with an acceleration to it, perhaps, as the rate at which purchasing power diminishes is greater and the concept is applied to a wider array of transactions when IAS 29 is applied. A simple illustration is as follows:

CU100 of revenue generated in January by an entity in an environment where CPI in December 20x1 is 200 (January 20x0: 100) implies that a factor of 2 must be applied to the January revenue figures for them to be comparable with the revenues generated in December. Simply put, if a widget had a selling price of CU100 in January, that same widget will likely have a selling price of CU200 in December. The same principle would be applied across all the costs incurred by that entity as well as the cost of that widget which was CU80 in January will likely be CU160 in December, all things being equal. However, when one looks at the statement of financial position, differentiation is made between monetary and non-monetary items. Monetary items are already stated at their current values thus are not restated, whereas non-monetary items are restated using the applicable indices, i.e., based on when they were originated. Depreciation and amortisation amounts related to non-monetary amounts are similarly recomputed and equity balances are also restated. In an inflationary environment, it is therefore advisable for an entity to hold non-monetary assets as these will (hopefully) act as a store of value. Monetary assets are not restated, i.e., if the vendor sold a customer a widget for CU100 in January and the customer only settles the invoice in December, at its face value, then the vendor has essentially lost CU100 worth of value. In a period of high inflation, it serves the entity better to have more monetary liabilities than monetary assets as this will result in a gain on the net monetary position, i.e. the loss in the purchasing power of the liabilities will be greater than the loss in the purchasing power of the assets, leaving the company with a net gain in purchasing power. The opposite applies where the monetary assets are greater than the monetary liabilities.

This gain or loss on the net monetary position may also be derived as the difference resulting from the restatement of non-monetary assets, owners' equity and items in the statement of comprehensive income. Such gain or loss in monetary position that arises is included in profit or loss.

Taxes, particularly deferred taxes, will be recomputed based on the revised carrying values on the statement of financial position. The statement of cash flows will also be represented to reflect the measuring unit that is current at the end of the reporting period.

There are a few additional complications that entities

reporting in environments with severe hyperinflation face which present practical business survival and accounting standard application concerns for them. For instance, where an entity finds itself subject to government-imposed price controls (in an effort to stem the rising inflation perhaps), it is possible that the rate at which prices of inputs rises is higher than the rate at which the entity can put up the prices of its outputs, the result being that inflation will erode margins to a point of unprofitability. The same would also apply in an environment where the government regulates the exchange control environment and businesses have to rely on alternative sources for their foreign currency needs, which may mean that they pay much more than the officially determined rates of exchange in order to keep their businesses afloat. The rates at which CPI or exchange rates move in such environments may not always be in tandem with each other which makes the assessment of performance of the entity that much more difficult to keep track of.

The bottom line is that, in an hyperinflationary environment, a deft hand is required to steer the ship and a similarly shrewd mind required to analyse the performance of the organisation and make decisions on how best to deploy capital if any progress is to be made. This is not to say that there aren't any worthwhile investment opportunities in economies that are plagued by hyperinflation. There certainly are… its about finding the diamonds in the rough.

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