FrankelZacharia LLC

Certified Public Accountants

What Impact Will Inflation Have on Your Company's Financial Statements

With inflation at its highest in 40 years, business owners are reasonably concerned about how this will impact the business. Consumer prices have increased by 8.3%, according to the most recent figures from the U.S. Bureau of Labor Statistics. The rapid increase in the Consumer Price Index (CPI), which looks at shelter, food, clothing, transportation, medical, dental, medication and similar goods and services that people need for living on a daily basis, also has many people worried.

Similarly, the producer price index has risen by 11% over last year, barely decreasing from March's 11.2%, which was the highest increase for wholesale inflation on record, gauging the rate of inflation prior to hitting consumers. But what impact will these inflation rates have on your company's finances?

As inflation continues, there are several major impacts that you may see in your company. Overall, inflation often increases your direct costs of production while lowering consumer demand for your discretionary services and goods. In many cases, unless you can pass these cost increases to your clients, they may spread past your gross margin. Here's how several other factors in your financial statements can be affected by the high rate of inflation we're seeing.

- **Debts:** Does your business have loans? If they have variable interest rates, your interest rate may fluctuate, as the Federal Reserve threatens to raise interest rates at the fastest rate in 40 years to reduce inflation. The federal rate was raised 0.5% in May, with additional increases expected over 2022. Companies with variable-rate loans should switch to fixed-rate loans or apply for additional credit to lock in lower rates before the rate is increased again, while others reduce debt. Depending on the restructuring approach, it can be reported as modification, extinguishment of debt or troubled debt restructuring.
- **Inventory:** Companies use a wide range of methodology to determine the cost of inventory, which can include first-in first-out (FIFO), last-in first-out (LIFO) and average overall cost. Given that the U.S.' Generally Accepted Accounting Principles, or GAAP, measures inventory at the lower of either cost or market value/net realizable value, inflation can have an impact on the method that you choose, which can impact your company's profits as well as your ending valuation of inventory. This process also causes a range of trickle-down impacts on tax liability.
- **Investments:** Inflation makes public markets more volatile. As market values change the value of a company's investments, realized or unrealized losses or gains may result. This will impact the company's deferred tax liabilities and assets under GAAP This shift may require a change to a new method of accounting or even specific or special disclosures in the financial statement.

- **Overhead Expense:** When was the last time you went over your long-term contracts? From lease agreements to service provider contracts, many company contracts may feature escalation clauses which have been tied to the CPI or similar inflationary measurements. If it does, you may see increases in lease, contract or service payments. In a similar approach, other vendors or service providers may implement a rate increase during these already difficult times to protect their own profits, as their own overhead expenses increase during the inflationary periods.
- **Going Concern Disclosure:** Is the ongoing inflation creating a higher risk that your company will be able to continue in the future? During each reporting period, your company's management will need to consider if there are doubts about your company's ability to continue operating successfully. If there are problems emerging that create substantial doubt that your company will be able to meet its obligations on time over the next year, it's time to revise your existing budgets. As inflation soars, companies that are unprepared to deal with the impact may fail.
- **Goodwill:** To estimate the fair value of goodwill that you acquire during a period of inflation, businesses using GAAP processes should be consistently applying the same valuation technique every period. However, assumptions underlying the fair value estimates can change with inflation. For example, market participants often use higher discount rates when in an inflationary period, due to expected revised cash flows as expenses rise, customer behavior changes and product pricing is modified, impacting goodwill estimates.

Need Help?
If you're not sure how inflation will impact your company's financial statements, we can help. Let us help you determine how rapid inflation will impact your company's finances and develop a solid strategy to keep your company operating effectively during difficult times.

For additional information, please contact Frankel Zacharia at (402)496-9100
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