The Value Relevance of Inflation-Adjusted and Historical-Cost Earnings During Hyperinflation

Ran Barniv

In Israel, publicly traded companies have been required to present financial statements based on the real purchasing power of the Israeli currency since 1985. Supplementary historical-cost data are provided in detailed notes to the financial statements including the balance sheet and the income statement. In the U.S., the FASB (1986) made the requirement to disclose the effect of price changes on earnings optional (SFAS 89). Consequently, publicly traded companies began suppressing inflation-adjusted earnings (IAE) disclosures. Most studies conclude that current cost earnings and constant dollar earnings provided marginal or even no information content in the U.S. This study examines the value relevance of unexpected IAEs and historical-cost earnings (HCE) in the Israeli hyperinflationary environment. A sample of 106 publicly traded manufacturing firms is used. The sample comprises over 97 percent of the publicly traded manufacturers in Israel during the mid-1980s. Cross-sectional annual and pooled regression models are estimated across the triple-digit annual inflation rates from 1984 through 1985 and the double-digit rates from 1986 through 1988. The results show that unexpected IAEs are value-relevant beyond unexpected HCEs, which are not value-relevant to investors in the hyperinflationary Israeli economy. The findings tend to be statistically significant when unanticipated inflation rates are notably high.

Key Words: *Inflation-Adjusted Earnings; historical-cost Earnings; Hyperinflation; Return (Price)-Earnings Relation; International Accounting; Alternative Accounting Procedures*

Introduction

During the early 1980s, the U.S. annual inflation rate decreased to less than five percent, which induced the Financial Accounting Standards Board (FASB) to

Ran Barniv •Department of Accounting, Graduate School of Management, Kent State University, Kent, OH 44242; Phone: (330) 672–2545, ext. 379; E-mail: rbarniv@bsa3.kent.edu.

Journal of International Accounting, Auditing & Taxation, 8(2):269–287 ISSN: 1061-9518

make price-level disclosures optional (SFAS 89; FASB, 1986). Consequently, publicly traded corporations suppressed inflation-adjusted earnings disclosures. Many other countries, however, experience triple-digit and double-digit inflation rates. Several of these countries require that publicly traded firms disclose accounting information adjusted to changing prices. For instance, most publicly traded companies in Mexico have been required to disclose some inflationary adjustments since 1980.[1] Since 1976, Brazil has employed an inflation accounting practice known as monetary correction (Doupnik, Martins, & Barbieri, 1995).[2]

In Israel, all publicly traded companies have been required to present financial statements based on changes in real purchasing power since 1985. Supplementary historical-cost data are provided in detailed notes which include summaries of the balance sheet, income statement, and details on the adjustments necessary for deriving net income[3]. Prior to the current requirement, supplemental inflation-adjusted notes were reported during the period 1979–1984. Inflation-adjusted financial statements have been required since triple-digit annual inflation rates prevailed from 1979 through 1985 and double-digit annual inflation rates of less than 20 percent continued from 1986 to 1994. For example, during the period 1984–88, annual increases in the consumer price index (CPI) ranged from 445 percent to 16.1 percent.

Since the crisis of Summer 1998, volatile economies and business environments in many countries have generated short-term inflationary or deflationary pressures across the globe. The expected shortage in energy sources by 2010, or at the latest, 2020, may yield an increase in long-term inflation rates. Therefore, inflation-adjusted accounting may provide useful information to investors in many countries. Increasing investments in foreign stock exchanges coupled with potentially high inflation rates may require worldwide inflation-adjusted disclosures. Several related international standards have been issued by the International Accounting Standards Committee (IASC). For example, IAS 29 (1989) was issued for financial reporting in hyperinflationary economies. IAS 29 requires the restatement of general price-purchasing accounting (similar to constant dollar accounting) in hyperinflationary countries, regardless of whether current cost accounting is already being used (Goldschmidt, 1992).

The hyperinflationary environment in Israel during the 1980s provides a distinctive setting for investigating the value relevance of inflationary disclosures.[4] The purpose of this study is to examine the incremental information content of inflation-adjusted disclosures for investors in Israel. The study focuses on the cross-sectional relationship between returns (prices) and unexpected historical-cost or inflation-adjusted earnings. The major objective is to examine whether inflation-adjusted earnings (IAE) are value-relevant beyond historical-cost earnings (HCE).

The incremental information content of inflation-adjusted disclosures has been controversial, producing, for example, conflicting conclusions in U.S. studies (e.g., Beaver, Griffin, & Landsman, 1982; Bublitz, Frecka, & McKeown,