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Using Inflation Accounting Tools to Enhance the Qualitative Characteristics of Financial Statements

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Abstract: This study aimed to highlight the role of inflation accounting tools in enhancing the qualitative characteristics of accounting information contained in financial statements. Under conditions of economic instability and continuous price increases, financial statements prepared according to the historical cost principle lose their ability to reflect the true financial reality of entities, negatively affecting their relevance and credibility. Accordingly, the study attempts to explain how alternatives to historical cost contribute to providing information that faithfully represents financial positions and increases users' ability to compare and make sound economic decisions. The study concluded that applying inflation accounting tools is an absolute necessity to protect the entity's real capital and improve the quality of financial reporting by meeting the fundamental and enhancing qualitative characteristics of information.
Keywords: Inflation accounting; historical cost; qualitative characteristics; financial statements;quality of accounting information.

1. Introduction:

Financial statements are the primary communication tool between an entity and its surrounding environment, as various parties such as investors, creditors, and government agencies rely on them to make their economic decisions. For these statements to perform their role effectively, their information must be of high quality, based on the qualitative characteristics of accounting information such as relevance, faithful representation, comparability, and understandability.

However, traditional accounting fundamentally relies on the historical cost principle and the assumption of a stable monetary unit, which represents a significant challenge during times of inflation. The continuous and notable rise in the general level of prices erodes the purchasing power of currency, making the figures appearing in traditional financial statements misleading historical numbers that do not reflect the entity's current reality, which in turn leads to a decline in the quality and usefulness of this information. Hence, the importance of inflation accounting emerges as an alternative system offering advanced accounting tools and models, such as adjusted historical cost accounting, current cost accounting, and adjusted current cost accounting.

1.1 Research Problem:

The research problem lies in the failure of traditional financial statements prepared on a historical cost basis to meet users' needs under inflationary conditions. The study seeks to answer the main question:

How do inflation accounting tools contribute to enhancing the qualitative characteristics of financial statements?

1.2 Objective

We attempt below to show which of the inflation accounting methods contributes most to enhancing the quality of financial statements, focusing on how these methods enhance the qualitative characteristics of accounting information (relevance, reliability, comparability, understandability).

Both relevance and reliability are the primary characteristics of accounting information according to the US Financial Accounting Standards Board (FASB, 1980). These two characteristics, along with understandability and comparability, represent the qualitative characteristics of accounting information according to the International Accounting Standards Committee (IASC, 1989) (Talab, 2016, p. 477).

2. Methods:

This study adopts a "theoretical, analytical, and comparative approach". No primary empirical data were collected. The method consists of a critical literature review and comparative analysis of five accounting measurement models against four qualitative characteristics of accounting information.

2.1 Analytical Framework:

Each accounting model was evaluated based on how it performs with respect to:

- Relevance
- Reliability
- Comparability
- Understandability

2.2 Models Compared:

The following five models were analyzed:

1. Historical Cost
2. Adjusted Historical Cost (general price level accounting)
3. Current Cost (including replacement cost, net realisable value, and present value)
4. Fair Value
5. Adjusted Current Cost

2.3 Evaluation Criteria:

In addition to the four qualitative characteristics, each model was assessed against two technical errors (as summarized in Table 1 of the original article):

- Measurement unit errors (using a nominal monetary unit with unstable purchasing power)
- Timing errors (delaying recognition of value changes due to realisation principle)

2.4 Data Sources:

The analysis draws on:

- Accounting standards (FASB, 1980; IASC, 1989)

- Peer-reviewed articles (Talab, 2016; Ben Yekhlef & Zeabbat, 2020; Miraj & Hadidi, 2017; Al-Najjar, 2013)
- Textbooks (Choi et al., 2004; Halwa Hanan, 2003; Wasfi, 2004; Mouzarin & Berbari, 2018)

3. Results:

3.1 Historical Cost:

Characteristic	Finding
Relevance	Irrelevant – ignores value changes, leading to incorrect decisions (Ben Yekhlef & Zeabbat, 2020, pp. 43-44).
Reliability	Reliable – based on external evidence (Ben Yekhlef & Zeabbat, 2020, p. 43).
Comparability	Difficult – comparisons across periods become difficult; revenues and expenses expressed in different purchasing powers (Talab, 2016, p. 484; Choi et al., 2004, p. 295).
Understandability	Clearly interpretable but misleading – users may not all understand inflation's impact (Halwa Hanan, 2003, p. 168; Choi et al., 2004, p. 295).

3.2 Adjusted Historical Cost:

Characteristic	Finding
Relevance	More relevant – discloses inflation effects and gains/losses on monetary items (Wasfi, 2004, p. 484).
Reliability	Verifiable – uses standard numbers from government agencies (Wasfi, 2004, p. 484).
Comparability	Enhanced – allows comparison across time and between entities (Halwa Hanan, 2003, p. 105; Wasfi, 2004, p. 484; Mouzarin & Berbari, 2018, p. 61).
Understandability	High – easy to apply; user does not need to study inflation effects separately (Halwa Hanan, 2003, p. 106).

3.3 Current Cost:

Characteristic	Finding
Relevance	Relevant – separates operating profits from holding gains; useful for evaluating management (Ben Yekhlef & Zeabbat, 2020, p. 45).
Reliability	Weaker – relies on personal estimation (e.g., replacement cost, net realisable value) (Ben Yekhlef & Zeabbat, 2020, p. 45).
Comparability	Best comparisons between entities.
Understandability	Interpretable – relies on maintaining productive capacity (Halwa Hanan, 2003, pp. 170-173), but difficult to apply.

3.4 Fair Value:

Characteristic	Finding
Relevance	High – reflects financial markets' estimate of present value of future cash flows (Miraj & Hadidi, 2017, p. 114).
Reliability	Conditional – reliable only if active markets exist; otherwise subjective (Miraj & Hadidi, 2017, p. 114).
Comparability	Mixed – lacks consistency due to multiple valuation models, but helps compare similar entities (Miraj & Hadidi, 2017, p. 114; Al-Najjar, 2013, p. 469).
Understandability	Complex – users need clear distinction between objective and estimated numbers (Al-Najjar, 2013, p. 471).

3.5 Adjusted Current Cost:

Characteristic	Finding
Relevance	Relevant – considers current value changes and both purchasing power and physical capital maintenance (Ben Yekhlef & Zeabbat, 2020, p. 46).

Characteristic	Finding
Reliability	Weak – non-objective, relies on personal estimation and difficulty finding price indices (Ben Yekhlef & Zeabbat, 2020, pp. 45-46).
Comparability	Allows comparison – provides homogeneity among elements.
Understandability	Difficult – hard to apply or use.

3.6 Comparative Summary (Measurement and Timing Errors):

Based on Table 1 in the original article:

Model	Measurement Unit Errors	Timing Errors
Historical Cost	Yes	Yes
Adjusted Historical Cost	Eliminated	Yes
Current Cost	Yes	Eliminated (except adjusted replacement cost)
Adjusted Current Cost	Eliminated	Eliminated (most efficient model theoretically)

4. Discussion:

4.1 Trade-offs Between Qualitative Characteristics:

The results reveal a consistent tension between relevance and reliability. Historical cost is reliable but irrelevant under inflation. Current cost and fair value are more relevant but less reliable due to reliance on estimation. Adjusted historical cost strikes a balance by using government-adjusted indices, achieving verifiability and relevance simultaneously.

4.2 Theoretical Superiority of Adjusted Current Cost:

The comparative analysis shows that only the adjusted current cost model eliminates both measurement unit errors and timing errors. This makes it, in theory, the most capable of enhancing all four qualitative characteristics during inflationary periods. However, its practical application is hindered by complexity and difficulty of understanding for users.

4.3 Practical Challenges:

- Fair value in developing environments (e.g., Algeria) must be adapted to actual market conditions; without active markets, subjectivity increases and reliability decreases.
- Understandability decreases as models become more sophisticated: historical cost is easiest to understand but most misleading; adjusted current cost is most accurate but hardest to use.
- Comparability is best achieved when all entities follow the same model consistently, but inflation forces adjustments that may reduce cross-sectional comparability.

4.4 Implications:

Enhancing qualitative characteristics is no longer an intellectual luxury but an absolute necessity to ensure financial market efficiency and sound investment decisions. Inflation accounting tools provide a truer mirror of an entity's financial position. Ignoring inflation leads to:

- Improper measurement of operating results
- Violation of the matching principle
- Loss of user confidence
- Non-aggregability and non-comparability of data

4.5 Limitations (Theoretical):

This study is conceptual and does not empirically test the models using real-world financial data. The conclusions are based on logical analysis and prior literature. The applicability of fair value and adjusted current cost may vary significantly depending on the regulatory and market environment (e.g., developed vs. developing economies).

5. Conclusion:

The purchasing power of the monetary unit changes during inflationary periods, which means the stable monetary unit assumption does not hold. Ignoring this change leads to measurement errors and timing errors, affecting the going concern assumption and various accounting principles. Relying on historical cost results in improper measurement of operating results, violates the matching principle (matching current revenues with historical expenses), and produces less reliable and less relevant information.

Main conclusion: Applying inflation accounting tools is essential to protect the entity's real capital and improve financial reporting quality. Among the models:

- Adjusted historical cost eliminates measurement unit errors and maintains reliability.
- Current cost eliminates timing errors and recognises holding gains early.
- Adjusted current cost is the most comprehensive theoretical solution but faces practical challenges.
- Fair value must be adapted to actual market conditions in developing environments.

Ultimately, inflation accounting transforms misleading historical numbers into information with high predictive and confirmatory value, thereby enhancing the fundamental and enhancing qualitative characteristics of financial statements.

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