CHAPTER - I

INTRODUCTION
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Inflation is like the weather, everyone talks about it but no one does anything about it. Like the weather, which is thus far beyond our control, we can take certain defensive measures to offset the impact of inflation just as we build shelters with heat or cooling devices to escape the consequences of inclemency. However, unlike the weather, inflation is a manmade phenomenon. Unless the genie has been let out of the bottle, what man has created should be amenable to control or prevention. Instead of passive submission to the inevitability of inflation, as with a volcano, it should be possible not only to moderate its effects but to prevent it altogether.

Yet most economies in the world, including India, have not had much success in dealing with inflation. Inflation remains a matter of substantial concern because of its seeming inevitability, persistence and apparent immunity to numerous remedies, except at "unacceptable" social costs. The weather is tolerated because we are helpless to control it; inflation is not, because it is (or is thought to be) controllable at least within tolerable limits.

Prices do not remain constant over a period of time. They tend to change due to various economic, social or political factors. Changes in the price levels cause two types of economic conditions, inflation and deflation. Inflation may be defined as a period of general increase in the prices of factors of production whereas deflation means fall in the general price level. These changes in the price levels lead to inaccurate presentation of financial statements which otherwise are prepared to present a true and fair view of the company's financial health. This is so because the financial statements are prepared on historical costs on the assumption that the unit of account, i.e rupees in case of India, has static value. But the assumption is not valid because the value of the unit of account, i.e, the purchasing power of the rupee has been changing ever since the beginning of this century. After the First World War, during 1918-23, there was a period of higher inflation in Germany. But it was only after the Second World War that the prices started
rising continuously and it made a non-sense of presenting the financial statements on historical cost basis.

The continuous inflation has an adverse effect on household budgets, as well as business and industry. Because of the continuous increase in prices, that is, decline in the value of Indian rupee, a demand has been made in accounting area that business enterprises should prepare inflation-adjusted financial statements in place of historical cost-based financial statements which are currently prepared by them. During the last few years, various accounting bodies, professional institutes, accountants and academicians have conducted a great deal of research and experimentation on accounting for changing prices. The present study aims to provide a comprehensive analysis of the concepts, issues and techniques in inflation accounting practised in the country like India and more specifically in the industrial units like NALCO. However, before discussing these aspects it would be proper to evaluate the strengths and weaknesses of statements under historical cost accounting, especially during periods of inflation and has been properly dealt in.

The term 'Inflation Accounting' generally refers to an examination of the accounting implications of general price level changes and specific price changes (which may be relevant even when the general price level is stable, i.e when there is little or zero inflation).

Inflation Accounting is simply “the methods of recognising and stating the effects of inflation in the final accounts of a corporate entity”. Dictionary definitions have generally referred to inflation accounting as an exceptional or inordinate rise in prices. Inflation can also be defined as an increase in the general price level. General price level is the weighted average of the prices of all goods and services in the economy.

Inflation Accounting has become an important and constant fact of life. Many countries of the world has received wide attention by accounting academicians and professionals in financial accounting in the last few decades. Inflation accounting is a generic expression connoting any of the
phrases like Accounting for Price Level Changes (APC), Price Level Accounting, Replacement Cost Accounting, Current Cost Accounting (CCA), General Purchasing Power Accounting (GPPA) etc. Researches of the United States of America, the United Kingdom, Australia and Canada have given serious thought to this problem and has conducted various researches in this field. They have also recommended some tools to fight against the effect of inflation on the historically and traditional accounting practices.

Inflation Accounting strikes at the very foundations of accounting embedded in the stability of the monetary unit. Conventional or historical cost accounting ignores price level changes in the preparation of accounts. As a consequence, financial statements fail to reflect the true financial position and operating performance of an entity during inflation. Historical costs are matched with current revenues resulting in overstatement of profits. Assets are understated in the balance sheet while gain/loss arising on monetary items is ignored. Appraisal of investment projects becomes difficult. Hence, there arises the need for a serious reappraisal of the usefulness of historical cost data during a period of inflation. Notable contributions have been made by academicians and accounting bodies in countries like U.K, U.S.A, Canada etc, to provide a lasting solution to the problem and make the accounts more meaningful during inflation. Unfortunately, the ongoing debate on this topic has not aroused much interest in our country despite a substantial price rise in the last two decades.

In this study, an attempt has been made to focus on the theoretical and practical issues surrounding this controversial topic and to provide a solution or model to help mitigate the impact of inflation on financial statements (in the light of efforts made by the Indian Corporate Sector, to date) and present a more realistic picture of the state of affairs.

OBJECTIVES OF THE STUDY

The study has been undertaken with the following objectives in view:

a. to examine the need, the various approaches to, and the conceptual underpinnings of inflation accounting;
b. to review the international developments in this field, especially in U.K. and U.S.A;
c. to examine the legal framework in our country in this context;
d. to study the manner and extent to which inflation accounting has been adopted by Indian Companies;
e. to undertake a case study of an Indian Company to show the impact of inflation on its financial statements by adjusting the accounts using Constant Purchasing Power Accounting (CPPA) and the Current Cost Accounting (CCA) methods;
f. to suggest a proposed accounting framework for reporting in an inflationary environment in India.

HYPOTHESES

In view of the objectives of the study, our hypotheses are as follows:

1. In India, the concept of Inflation Accounting and its practical application has taken a back seat so far as it relates to the Corporate World.
2. There are certain valid reasons behind the non-adoption of inflation accounting techniques in their preparation and presentation of inflation accounting information by the Indian Corporates.
3. There are a few exceptions to the rule and now-a-days a number of organisations have started presenting their financial statements along with adjustments with the change in prices.
4. This practice is bound to grow with the time and once its utility in business decision making is ascertained and confirmed there will be a large number of business entities who will adopt measures to reflected price changes in their financial presentation.
5. Financial statements do not reflect a true and fair view of the financial position and operating performance of an entity during a period of inflation.
6. Among the alternative techniques, CCA is more popular than CPPA in India.
RESEARCH METHODOLOGY

The present study entitled "Impact of Inflation on Economic Performance of Indian Industries – A Case Study of NALCO" is an empirical study reflecting the impact of inflation on its financial statements by adjusting the accounts using Current Purchasing Power Accounting (CPPA) and the Current Cost Accounting methods over a period of ten years covering from 1994-95 to 2003-04. The study is based on both primary and secondary sources of information. The secondary data have been collected from the published reports, books, journals, leaflets of the NALCO, reports of different committees, Government of India, Parliamentary Committee Reports, articles from different journals and information from the internet sites. The information so collected have been supplemented by the published information collected form the corporate office of NALCO, libraries and International Iron and Steel Institute, Brussels. Besides, a questionnaire was mailed to the sampled companies to conduct a survey for examining the inflation accounting techniques adopted by Indian Companies. However, in view of the poor response from the companies comprising the sample, an attempt was made to identify companies actually publishing inflation adjusted data and the methods adopted by them, by scanning the available annual reports of various companies.

The information collected from both the primary and secondary sources have been classified, tabulated and subject to various statistical and mathematical analysis such as percentages, ratios, compound growth rate, averages etc., for better understanding and interpretation. Even though the present study covers information up to 2003-04, in some cases the most recent available information have been incorporated to make the analysis more relevant to the time.

The historical cost based Balance Sheet and Profit and Loss Account of National Aluminium Company Limited (NALCO) for the years 1994-95 to 2003-04 have been restated to express them in constant rupees of 31st March, 2004. The Index Number of Wholesale Prices – all Commodities,
Machinery and Machine Tools, Manufactured Products in India published by the Office of the Economic Advisor (Government of India, New Delhi) have been used for restatement process. The conversion factor have been calculated by the following formula:

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\text{Equivalent number of current rupee.} = \frac{\text{Historical cost} \times \frac{\text{Average price index for current year}}{\text{Index at the date of historical cost}}}{\text{Index at the date of historical cost}}
\]

For others, statistical methods like increase, decrease, percentage of changes and others are calculated by using computer – M STAT, Ms-Excel program for the purpose.

PERIOD OF CASE STUDY

The present study period covers a ten year period from 1994-95 to 2003-04. The company's (NALCO) financial year ends on 31st March.

COLLECTION OF DATA

Data for the purpose of the study have been collected basically from the secondary sources. Annual reports of NALCO (National Aluminium Company Limited) from the years 1994-95 to 2003-04 were the main source of data for the case study. Detailed information necessary for analysis was not furnished by the company. Hence annual reports of a few years prior to 1994-95 were also examined to seek relevant details for analysis of data as and where required.

Index numbers of Wholesale Prices in India- all Commodities, Machinery & Machine Tools and Manufactured Products (monthly bulletin) published by the Office of the Economic Advisor, Government of India, New Delhi, have been used for adjustment of historical cost data.
TECHNIQUES EMPLOYED

The impact of inflation on financial statements has been shown by applying the CPPA and CCA methods and analysing the results with the help of ratios. Wholesale Price Indices have been used for adjustment of historical cost data.

SCOPE OF THE STUDY

Most of the discussion on inflation accounting appears to focus attention on the principles, theories and practices in enterprise accounting. Apparently, a little too much emphasis has been placed on this aspect; because, most of the professional accountants are either in the service of enterprises or render a service to enterprises in their capacity at cost, financial and management accountants, auditors and income-tax practitioners. Even the Fifth Conference of Asian and Pacific Accountants which devoted much of its time to inflation accounting concentrated attention on enterprise accounting; and more particularly, to the medium and large size enterprises which utilise the services of professional accountants in one capacity or another.

There appears to be an urgent need for rationalisation of attitudes of the accounting profession towards the “service of the people”. It is high time the accounting profession took pains to develop suitable techniques which can be employed as tools for maximisation of productivity of available factors of production by the small sector, household and cottage industries and agriculture. They account for almost 80 p.c. of India’s gross domestic product. Such tools of accounting would help the ‘People’ to appreciate the effect of inflationary trends in the matter of the unit prices of inputs and improve the decision making process of the owner, managers in these sectors of the national economy. Appropriate early development and prompt utilisation of these techniques in inflation accounting, rooted to the ground level of existing environments, will provide a much needed service by the profession to the ‘People’ towards their attainment of better standards of living and higher status of happiness.
The technology of inflation accounting should also be extended to the interpretation of data in social accounting. The effect of inflationary trends, in so far as, they create or widen regional, zonal or group imbalances and distortions will have to be studied in depth. Application of the tools of inflation accounting to the interpretation of data in social accounting does not appear to have attracted due attention so far. The application of technology of accounting to input-output models in social accounting would open a new vista to the accounting profession.

Application of this technology to interpretation of data in "national accounting" is yet another aspect on which adequate attention has not been focused so far. The effect of the inflationary trends, in accounting terminology, towards distribution of wealth and income and its effect on the socio-economic development of the 'people' may lead to a new line of thinking. It is quite likely that, as a result of these inflationary trends, there is a considerable erosion in the Nation's Reserve of Human Capital. A rough quantification may be feasible.

The application of this technology to interpretation of data pertaining to the operations and activities of the government in its quasi-commercial and development departments appear to be yet another field which is bound to yield instructive results. This has not been attempted, so far, on any significant scale. Considering that the size of the government operations has been increasing at a very fast speed, this delay is rather unjustified. Cost-benefit analysis of major government operations for ascertainment of the status of achievement of the defined objectives, under historical cost system, and interpretation of the effect of the inflationary trends on these, in inflation accounting, require far more urgent attention from the accounting profession.

IMPORTANCE OF THE STUDY

In the past few years of high inflation, companies have reported very high profits on the one hand but on the other they have faced real financial difficulties. This is so because in reality dividends and taxes have been paid
out of capital due to overstated figures of profits arrived at by adopting historical cost concept. Thus, a change from historical cost concept to price level or inflation accounting has been recommended. The major importance of Inflation Accounting are as follows:

(i) It enables company to present more realistic view of its profitability because current revenues are matched with current costs.

(ii) Depreciation charged on current values of assets in inflation accounting further enables a firm to show accounting profits more nearer to economic profits and replacement of these assets when required.

(iii) It enables a company to maintain its real capital by avoiding payment of dividends and taxes out of its capital due to inflated profits in historical accounting.

(iv) Balance sheet reveals a more realistic and true and fair view of the financial position of a concern because the assets are shown at current values and not on distorted values as in historical accounting.

(v) When financial statements are presented, adjusted to the price level changes, it makes possible to compare the profitability of two concerns set up at different times.

(vi) Investors, employees and the public at large are not misled by inflated book profits because inflation accounting shows more realistic profits. Higher Paper profits without adjustment for price level changes cause resentment among workers and they demand higher wages and also excessive profits attract new entrepreneurs to enter the business. Inflation accounting helps in avoiding further competition from prospective entrepreneurs.

(vii) The financial statements prepared by a company adjusted to the price level changes also improve its social image.

(viii) Inflation accounting also affects the investment market as it helps to establish a realistic price for the shares of a company.
PLAN OF THE STUDY

The study is divided into six chapters including conclusion.

The introduction chapter discusses the background of the study. The chapter includes by highlighting the conceptual framework, its objectives, hypotheses, research methodology, data base, techniques employed, scope of the study, importance of the study and limitations of the study. Chapter-II deals with a theoretical perspective relating to Inflation Accounting. Chapter-III deals with the methodology and Inflation Accounting policies. Chapter-IV reviews the various proposals put forward by accounting bodies, research committees and academicians to account for inflation in different countries. Chapter-V is a study of the inflation accounting practices in National Aluminium Company Limited (NALCO). Chapter-VI contains the summary of major findings, conclusions and suggestions and also presents a proposed accounting framework for reporting in an inflationary environment in our country.

LIMITATIONS OF THE STUDY

The present work is based on the information obtained from the published annual reports of the NALCO. Efforts were made to elicit as much as possible by means of questionnaire and personal interviews with the senior executives. However, non-availability of transactions wise financial information in some cases, the use of arranging and approximate the result of the present study is also influenced by the limitations of wholesale price index number which has been used for adjustment purpose.