CHAPTER – II

INFLATION ACCOUNTING – A THEORETICAL PERSPECTIVE
Accounting is a service activity. Its main purpose is to provide quantitative financial information for decision making in a business. The accounting activities form a progression of steps beginning with observing, collecting, recording, analysing and finally communicating information to its ultimate users viz. creditors, investors, government, trade unions, management and researchers etc\(^1\). In other words, accounting process involves the accumulation analysis, measurement, interpretation, classification and summarisation of the results of each of the many business transactions that affect the business concern. Such financial information is usually reported to the various users through the financial statements which are prepared based on certain accounting concepts and conventions. A concept is known to be an abstract idea serving a systemising function. Convention on the other hand refers to a statement or rule of practice which by common consent expressed or implied is employed in the situation of a given class of problems or guides behaviour in a certain kind of situation.

The existing accounting practice of preparation of financial statements are based on an important accounting concept namely the monetary concept. Money is common measuring unit of transactions which are recorded in the books of account. Only those transactions which can be measured in money are taken into consideration and recorded in the books of accounts. In India, this measuring monetary unit in 'rupee' (dollar in the U.S.A. and Pounds in the U.K.) etc., is stable and that fluctuation in value of money may be ignored in the preparation of accounting statement. But with the passage of time and subsequently with change in the value of money due to inflation the assumption of a stable monetary unit does not hold good and creates a numerous problems in the preparation of accounts in various ways, thus the subject of inflation accounting now-a-days has received a wide attention in financial accounting due to severe inflation any trend prevailing in many countries of the world. Because of the increase in prices, a demand has been made that business enterprises should prepare inflation adjusted financial

statements in place of historical cost based financial statements. This is so as historical cost accounting does not contain useful information to satisfy the needs and purposes of management as well as external users. Historical Cost Accounting also known as conventional accounting, records transactions appearing in both the profits and loss account and balance sheet in monetary terms, which reflect their historical cost. Historical cost is a concept that relates to the cost actually incurred or the amount actually paid in acquiring or availing the assets or services. Historical cost, therefore, means the original cost or the acquisition cost. The historical principle requires that accounting records which are maintained at original transaction prices and these values are retained throughout the accounting process to serve as the basis for values in the financial statements\(^2\). Also, the historical cost accounting is based on the realisation concept, which requires the recognition of revenue when it has been realised. The realisation concept has an important implication affecting both the profit and loss account and balance sheet. This concept requires that only realised revenue should be included in the financial statement.

The historical cost accounting has certain advantages. It is considered free from bias, more reliable and independently verifiable. It reduces to a minimum extent to which the accounts may be affected by personal judgements of those who prepare them. It is the only legally recognised accounting system accepted as a basis of taxation, dividend declaration etc. Finally, historical cost accounting is least costly to society considering the costs of recoding, preparing, reporting and auditing. Inspite of all above advantages the historical cost accounting is not free from criticism. The serious limitations are:

Firstly, the historical accounting is based on the assumption of stable monetary unit, which assumes that there is no inflation or deflation. This

assumption does not prove true during inflation or deflation which changes are found in general price level or specific price level.

Secondly, it does not match current revenues with current costs of operations. While some costs like wages and other operating expenses reflect current costs but the other costs like cost of goods sold and depreciation may not represent the current costs. Accordingly, historical cost accounting results to report overstated profit during a period of increasing prices. This overstated profit in historical cost accounting is not the real profit but exaggerated and illusory. Because as per the historical cost convention, fixed assets of an enterprise are taken for depreciations purpose to have been purchased at uniform prices though in practice they are purchased at various prices in the past. The total amount of depreciation provided over the working life of the asset is equal to the original money cost of asset if we assume that the scrap value of the asset is nil. Then it is obvious that there would be no difficulty in financing the replacement of the used up asset if the prices have not changed. But with the changes in money value replacement of assets becomes impossible with that amount. It is so because the depreciation provision based as it is on the original money investment in fixed assets represents an amalgam of cost incurred at various points of time and does not represent the same amount of purchasing power as was originally invested in the assets exhausted during the operation. This results that when the level of prices goes up the historical cost basis of depreciation provision causes a gap between the annual depreciation provision and the cost of the used up portion of the asset both measured in terms of purchasing power. Such difference is cumulative in nature over a long period of time and leads the firm into critical position to replace existing fixed assets.

Thirdly, the balance sheet prepared on the basis of historical cost accounting does not truly represent the resources held by an enterprise at the balance sheet because on the balance sheet the asset are represented at lower amounts because fixed assets are recorded at the original monetary costs invested at the time of their acquisition.
Fourthly, another factor responsible for causing distortions to historical cost accounting is the cost of inventory which is shown at cost or market price which is lower. Sales, on the other hand, are shown at current purchasing power of the rupee. Thus, profit disclosed by financial accounting based on historical cost accounting does not represent increase in wealth of business in terms of the current purchasing power because inventory is not realistically valued at their current value.

Finally, the other factor responsible for distortions to historical cost accounting is purchasing power gains and losses which occur simply because a concern is holding some monetary liabilities and assets. These results gain or loss purchasing power during inflation. These gains and losses are in the nature of costs of holding monetary assets and liabilities and should be taken into account which considering the effects of price changes on historical cost accounting.

In view of the above mentioned drawbacks of historical cost accounting, there is a need to restructure historical cost based financial statement or to develop alternative accounting system for accurate measurement of profit so also reliable reporting of financial position. Inflation adjusted financial statements would not only achieve this objectives of reliable profit and financial position measurements but would also prove useful to management and external users in their decision making. Since the high rate of inflation has gripped almost all the economies of the world has forced to different users such as corporate managers, accountants, academics, investors, government etc., to give a fresh look and consider whether the corporate accounts prepared on historical cost basis serve the purpose they are supposed to and whether some changes in accounting system is warranted. With a view to overcoming the problems related to the historical cost accounts a number of proposals has been made to incorporate the effects of inflation accounting. In some countries of the world, notably U.K., U.S.A and Canada the proposals have taken a definitive form and are already being implemented. In India also, a loud thinking is going about useful and suitability of the historical cost accounting in the context of higher rate of
inflation. Since the majority of the business enterprise in India does not seem to have made any worth mentioning attempt, a few of them have been attempted to incorporate the effects of inflation in their accounts.

Therefore, in view of the great significance of the subject for the business enterprises and its far-reaching implications for other users and the society at large a need is felt for the present study. The study will therefore, examine the existing system of accounting, suggest ways to provide inflation adjusted information to users and explore the possibility of adopting on long-term basis a system of accounting which has built in mechanism for adjusting to the changes in prices. The evaluation of corporate practices regarding financial accounting and reporting during inflation will be made.

IMPACT OF INFLATION ON FINANCIAL STATEMENTS

Accounting for inflation has been under consideration for quite some time but the debate still remains inconclusive. Inflation is socially divisive. Individuals who have savings largely in money assets and who are weak in wage-bargaining power become poorer day by day than those who have real assets and have exercised their power to borrow. They are becoming economically strong or and also richer. Nobody should wish other than success to Government which attempt to restrain inflation, but they are unlikely to be able to eliminate it completely, and to the extent that some inflation is countenanced by some Governments, they should be prepared to reduce its divisive impact. Some movements in this direction can be seen from a proposal on tax on property development schemes whereby the mortgage of house property receives an equity interest, the threshold provisions of the pay and prices policy. To compensate every situation where a person is at risk from inflation would undoubtedly reduce the strength of public support for anti-inflation policies, but it seems possible practice to draw a dividing line between the personal sector and the corporate sector. Inflation accounting in such situations is desirable, particularly when it leads to a fair distribution of tax among companies which other gain from inflation or lose from it. The problem is that the inflation adjusted accounts are not acceptable
to many public authorities mainly taxation authorities. At the same time corporate laws in all the countries require the companies to present a "true and fair" picture of corporate affairs in their annual reports. Therefore, even the present day requirements of the authorities are changing. Form the investors and creditors viewpoint, unless the publication of inflation adjusted accounts by the companies become the general practice, they have to make their own estimates of the impact of inflation on individual companies. During the past four decades there has been several proposals on how financial statements should be adjusted to show the effect of inflation when there were severe fluctuations in prices. The financial statements prepared on historical cost basis have become highly distorted. Balance sheet of a business does not reflect true value of assets and liabilities. The profits of different periods become incomparable to the present day. Also, the information disclosed by financial statements raised doubts regarding the soundness of investment decisions during inflation and hampers the ability of investors, creditors and others to derive useful information for making proper investment decisions and their appraisal.

Fixed assets shown in balance sheet become a meaningless conglomeration of resources purchased at varying costs in different years. The depreciation provision based on the original money investment of fixed assets represents and amalgam of costs incurred at various points of time and does not represent the same amount of purchasing power as was originally invested in the assets exhausted during operations. With inflation, the historical cost basis of depreciation widens the gap between the annual depreciation provision and the cost of used up portion of assets. As a result, the company faces difficulties in replacing the existing assets. Moreover, the depreciation provision when matched with sales at current prices leads to an inflated profit figure. In the balance sheet, assets are recorded at historical cost basis instead of current prices. Similarly, inventories are valued at their acquisition cost. Further, the historical cost of goods sold are matched with sales revenue at current prices. This results in an inflated profit figure referred to as inventory profit. Thus, a time lag error is said to arise when an account sets off cost of one price level against revenue of another and the size of the
error is equal to the appreciation in historical cost between the cost date and sale date.

Inflation makes a monetary liability less burdensome. The purchasing power represented by claims of creditors falls during a period of inflation representing a gain to business. At the same time, on the other hand, there is fall in the purchasing power of a bank deposit or an amount due from debtors, thus representing a loss to business. These gains and losses are in the nature of costs of holding monetary assets and liabilities. This should be taken into account while considering the effects of price changes on historical cost accounts. In fact, a favourable impact of inflation is the gain to equity holders due to the use of fixed charge securities in the capitalisation of a company and corresponding decline in purchasing power to fixed charge security holders. Since most business enterprises had higher debt than internal equity in their capital structure there were purchasing power gains due to excessive monetary liabilities. Therefore, management based on historical cost is suspect right form the early period and financial reporting over the year became 'massively sick with the virus of inflation'. If the effects of price changes events are ignored continuously in accounting, then we may soon find that financial reporting will have lost its usefulness and credibility. Therefore, there is a need for a suitable accounting system which can take care of the changing prices.

As regards approaches to inflation accounting, efforts so far made evolve a method of accounting for inflation have not succeeded. Attempts are of course, being made in this direction. The primary reason for this situation seems to be lack of clarity regarding the objectives of collecting and supplying relevant accounting information. The FASB of U.S.A. has brought into sharp focus the objectives of financial reporting by business enterprises by issuing Statement of Financial Accounting Concepts (SFAC -1). During the past four decades, discussions have mainly centered around two broad approaches viz. the general purchasing power (general price level index) approach and the current cost (specific price) approach. During the sixties preference seemed to be for general purchasing power while during the seventies and
latter on some variant for current cost approach was generally advocated. Business enterprises were largely of the view that specific price should be the basis for adjustment for inflation in accounts because it maintained the operating capacity i.e. capital intact. This approach, of course, has many limitations-comparability, subjectivity and understandability, being few among others. It is because of this that the concerned authorities in India are not adopting in toto the current cost account method as followed in U.K. The general purchasing power is found to be theoretically better and it would be used without much practical difficulty because this approach adopts a general price index hence the criticisms against the method do not hold much ground. Besides, the empirical studies undertaken and use of this method by companies to produce supplementary financial statements on an experimental basis have shown that this method can be used without much difficulty. Thus, the method has the advantages of objectivity, comparability and understandability among others.

As regards inflation accounting practices in some foreign countries viz. United States of America, United Kingdom, Canada, France, Belgium, Sweden, Japan, Germany, Australia and Italy, we have come to the conclusion that the accounting for inflation has been in practice for quite some time especially during the last half century. There have been several proposals on how financial statements should be adjusted to show the effects of inflation. These proposals are in the U.S.A, SFAS – 33 “Financial Reporting and Changing Prices” issued on September 1979 by the FASB. In Canada Section 4510 of Canadian Institute of Chartered Accountants (CICA) Hand Book, “Reporting the Effect of Price Changing” issued in Dec. 1982 by the Canadian Institute of Chartered Accountants, Toronto. In Australia Selective Exposure of Proposed Statement of Accounting Standard: “Current Cost Accounting Research Foundation, Melbourne”. In the U.K. SSAP – 16 “Current Cost Accounting” issued in March 1980 by the Accounting Standard Committee, London. The above proposals are not exhaustive but represents the serious effects made to come up with right answer for concepts and methods of adjusting financial statements for price changes.
The present position is that though there are very few countries which have officially adopted accounting for price level changes either as a superior substitute for historical cost accounting or supplementary to it but a general consensus is yet to be obtained as to the proper Accounting for Price Level Changes standard to be perused. Obviously, there was never a consensus on any one method. In fact, this has been the greatest hurdle in the way of almost of every country thinking of introducing some system of inflation accounting.

INFLATION ACCOUNTING IN INDIAN CONTEXT

The need of inflation accounting in India's Corporate Sector is felt invariably by all and Sundry, though only a few companies viz. Ashok Leyland Limited, Bharat Heavy Electricals Limited, Carborundum Universal Limited and Voltas Limited used inflation accounting by either current cost accounting method or general purchasing power method. But there is no unanimity among the respondents regarding the methods of inflation accounting they would like to recommend for adoption in India. Some preferred current cost accounting others has a choice for general purchasing power accounting, some liked a combination of the two methods, while majority felt that the inflation accounting was not relevant hence the choice of method does not arise. The above mentioned companies under study responded that they have used the inflation accounting methods just to know the impact of inflation accounting and for information purpose only. They are not intending to do the same in subsequent years. The greatest obstacles in the way of adopting inflation accounting are : practical difficulties in its implementation, non-acceptance of final accounts for tax purposes and difficulty in understanding such accounts. Inflation accounting by and large is done for management use only. The basic objectives of financial reporting does not seem to be considered significant in India. It is therefore, desirable to introduce inflation accounting in the Indian business, although the reasons given by the respondents to support the use of inflation – adjusted information differed a lot.
In view of the above analysis and discussions, the following relevant points may be adhered to while adopting a system of inflation accounting in any organisation.

First of all, there is a need to set up a high level committee. The problem of changing prices is going to stay more or less permanently. Consequently, serious efforts should be made by all concerned to evolve a system of accounting that can take care of both inflation and deflation. Accounting system is a function of legal, social, political, economic and other types of environment prevailing in a country. We need a system of accounting, which can meet the present and future needs of all types of users as also of the society. Professional bodies and academics have an important role to play in shaping the accounting system. In the U.S.A., U.K., Canada, Australia and France and many other countries, professional bodies have been doing a lot in this regard. In India, also the Accounting Standard Board of the Institute of Chartered Accountants of India (ICAI) and the Institute of Cost and Works Accountants of India (ICWAI) have been issuing standards. Twenty two accounting standards have been issued so far (up to June 2001) by (CICAI), which are almost wholly based on International Accounting Standards. India has a dominating public sector. Its requirements have also to be kept in view while issuing standards in India. It is suggested that a committee on the pattern of Accounting Standards Committee (ASC) of U.K. or Financial Accounting Standards Board (FASB) of U.S.A. should be formed in India. Such a committee should be representative body of financial accountants, cost accountants, management accountants, government accountants, public sector accountants and leading academics in the accounting area. This committee comprising of accounting professionals, intellectuals, and social thinkers should engage itself into studying the problem and came out with remedies and important in the system of presenting accounting inflation with view of in computing inflationary trends in the data.

This committee should issue statements and guidelines, which meet the requirements of India. Unlike the developed economies where such
accounting bodies are strong and make their voice heard by the Government, the proposed accounting committee in the developing economies will need government support without which the recommendation of such a committee will not be effective.

In order to provide managerial and administrative tool for maximisation of socio-economic progress, this committee on the pattern of Sandilands Committee in U.K., should like into the standardisation of concept, practices, terminology and technology of valuation accounting. The committee should also co-ordinate the activities of all the accounting bodies and association in this context and jointly issue a statement of standard accounting practice requiring the companies to follow the standards of current cost accounting as soon as possible.

Secondly, the Government Statistical Organisation should publish monthly, without such delays, a new series of price indices specific to particular industries for capital expenditure on plant and machinery by these industries in order to provide a standard reference basis, for current purchase price (Replacement Cost) of fixed assets other than land and building. For motor vehicles there should be a separate index. In case, where no specific indices are available, the indices to be used for valuation of corporate assets should have prior approval from the auditors, tax authorities, shareholders, Securities and Exchange Board of India and other bodies. The revaluation should become regular feature but where the cost of revaluation is higher, it could be done at a specific interval of 3 to 5 years.

Thirdly, the auditing profession should review its responsibilities from time to time in view of the certification regarding 'true and fair' and also the new horizons of their profession recently opened and recognised like social audit requirement in India. In order to gain exact information of the true profit situation all enterprises engaged in industry and commerce and other enterprises with significant non-monetary assets, determine at least for internal purposes the amount of profit that is required to preserve the operating capacity capital of the enterprises and thus for the continuation of
the enterprise and the security of its jobs. The results of this exercise may be disclosed in Director's annual reports to shareholders. Companies should show the 'value to the business' of their plant and machinery by reference to the appropriate official index and should state in a note to the accounts the reference numbers of official index or indices used unless the Directors consider that a different basis of valuation is more appropriate and is likely to provide a more precise figure. In that case, the Directors should show 'the value to the business' of the assets concerned on the basis the Directors choice on the basis of appropriate subject. Further where a change in the basis of valuation is made, the fact should be mentioned in the note and the change should be done only in consultation with the auditors, revenue authorities and shareholders.

Further, research needs to be carried out on the techniques of valuing stocks, especially the work-in-progress. In case of overseas operations, the valuation of assets held overseas should be assessed to their actual location and the basis of such valuation be disclosed in the accounts and should be approved by the auditors. The translation of results of overseas operations should be done after drawing up the accounts of those operations on a Current Cost Accounting basis.

Marketable securities should be shown in the balance sheet at their market value. The net book value of assets on a historical cost basis and the historical cost depreciation should continue to be shown in the notes to the accounts. The annual accounts should include a funds flow statement and the Directors be required to give a statement on the adequacy of the cash and other liquid resources likely to become available to meet the company's requirements in the ensuing years. Land and building should be valued on the 'existing use' basis. Where these represent a material element of a company's assets, valuations should be prepared with the advice of independent valuers. The valuation process should consist of ascertaining to what extent changed circumstances have influenced the previous estimates. Companies which are in a position to ascertain the current cost of each sale at the time it is made, should in future use these figures as the basis of the charge for cost of sales.
in their Current Cost Accounts. Other companies should calculate a 'Cost of Sales Adjustment' by applying 'averaging method' and show the calculations separately in the Profit and Loss Account.

Depreciation should be provided on all fixed assets except land. The backlog depreciation should not be charged against the Profit and Loss Account. In case where the basis of valuation of an asset is changed during the year, the depreciation should be calculated on the basis of the value shown in the balance sheet at the end of the year. Current Cost Accounts should be presented in such a way, that all 'holding' and 'extraordinary gains' are distinguished from 'Current Cost Profit'. Unrealised losses should be written off against Revaluation Reserve. A summary Statement of Total Gains or Losses for the year along with a statement showing the increase in purchasing power of shareholder's funds should be presented in the annual accounts. In the longer term it is recommended of the companies to present a 5 to 10 years summary table in the form of ratios. When fixed assets are revalued in accordance with the principles of Current Cost Accounting, amount for deferred taxation should be provided from the Revaluation Reserves. Finally, for the utilisation of the available technology of inflation and valuation accounting as a managerial tool for fighting inflationary trends, there is an urgent need for change in the methodology of business accounting, under inflationary trends. For evolution of managerial tools, leading to maximisation of productivity and optimisation of profit for maximisation of socio-economic, welfare of the 'people' as well as improvement in the status of their 'happiness' the accounting profession has to work continuously for presenting, analysing and interpreting the accounting data in an improved form. This will involve the departure from conventional accounting practices and change in the outlook, thought processes and behaviour pattern of accountants, in all walks of life. Delay in development and utilisation of this technology is likely to lead to considerable erosion of credibility in the integrity of the accounting profession by managers, administrators, executives, investors, creditors, government agencies and others. In view of the high rate of inflationary trends throughout the world, therefore, need for early development and utilisation of the available technology of inflation accounting
is highly significant and urgent. The implementation of the above recommendation, emanating from this survey and analysis of the area of valuation of corporate property and inflation accounting, will go a long way in meeting the current and future needs of presentation and disclosure of vital financial information in company reports. This will provide much needed realisation of the price level changes in the economy and their impact on company operations, management, liquidity and solvency.

**IMPACT OF INFLATION ON FINANCIAL ACCOUNTING**

Constant efforts are being made to improve the precision and usefulness of financial statements. Due to the uncertainty of economic conditions and complexity of business transactions, the financial statements should be accepted as tentative in nature and subject to certain limitations. Inflation has further eroded the usefulness of historical cost based financial statements. There are two main factors which augment the distortion of reported profits and financial position during inflation:

(i) **Understatement of depreciation provision and cost of goods sold:-**

The depreciation provision based on the original money investment in fixed assets represents an amalgam of costs incurred at various points of time and does not represent the same amount of purchasing power as was originally invested in the assets, exhausted during operations. With inflation, the historical cost basis of depreciation widens the gap between the annual depreciation provision and the cost of used up portion of assets (both measured in terms of purchasing power). As a result, the firm faces difficulties in replacing the assets. Moreover, the depreciation provision when matched with sales at current prices leads to an inflated profit figure. In the balance sheet assets are recorded at historical costs instead of current prices. Similarly, inventories are valued at their acquisition cost (or market price, if lower). Further, the historical cost of goods sold are matched with sales revenue at current prices. This again results in an inflated profit figure referred to as 'inventory profit'. Thus a time lag error is said to arise when an account
sets off cost of one price level against revenue of another and the size of the error is equal to the appreciation in historical cost between the cost date and sale date. In other words, the cost incurred are not recovered in full.

(ii) Purchasing Power Gains and Losses:-

Inflation makes a monetary liability less burdensome. The purchasing power represented by claims of creditors falls during a period of inflation representing a gain to business. At the same time, there is a fall in the purchasing power of a bank deposit or an amount due from debtors, thus representing a loss to business. These gains and losses are in the nature of costs of holding monetary assets and liabilities and should be taken into account while considering the effects of price changes on historical cost accounts. In fact, a favourable impact of inflation is the gain to equity holders due to the use of fixed charge securities in the capitalisation of a company (i.e. a high degree of financial leverage) and a corresponding decline in purchasing power to fixed charge security holders. If a firm is financed entirely through equity shares, a given percentage change in Earnings Before Interest and Taxes (EBIT) results in the same percentage change in Earnings Per Share (EPS). The use of fixed charge securities increases the responsiveness to changes in EBIT. Inflation is further instrumental, increasing not only EBIT but the rate of return on equity capital as well.

Inflation ultimately leads to:-

(iii) Financial strain on business :- Since the costs of carrying on the business are not fully recovered it leads to a financial strain on the business and a gradual depletion of cash resources. There arises a shortage of working capital due to inconsistent matching of costs of inventories consumed to sales. The inadequate depreciation provision leads to shortage of fixed working capital needed to finance replacement of assets and other growth activities. A number of factors contribute to the rise in the working capital requirements of a business enterprise.

(a) Rise in the prices of inputs and other costs:- Rise in the prices of industrial machineries and inputs leads to an increase in project cost.
Even if the scale of operations is maintained constant, the rupee amount of working capital requirements is large due to the rise in the prices of raw materials, stores and spares, fuel and power, wages etc.

(b) Scale of Operations:- Inflationary conditions by providing motivation of higher profits, induce entrepreneurs to increase the scale of operations and also make further investments. This again entails large working capital requirement.

To what extent financial managers are required to raise additional funds? The sources of working capital fall into two categories: external sources (deposits from public, creditors, bank loans, long term loans, debentures and shares) and internal sources (retained earnings and depreciation). Decisions relating to the proportion of funds to be raised from external sources involve three considerations viz. trade offs between risk and profitability, preferences of investors and purchasing power gains or losses associated with various sources. Other things being equal, greater the proportion of liquid assets, less the risk of running out of cash. But trade off decisions are very much influenced by the preferences of investors other things remaining the same, investors are more attracted by investments whose market values and also return on them would rise with inflation e.g. equity shares. Unlike the investors, the firm would gain substantially in terms of purchasing power if it chooses to raise funds through borrowings. Thus, the interests of the investors and the firm cash and the one with better bargaining strength gains.

(iv) Overstatement of profits leads to:

- 'Capital Levy' and 'capital distribution', i.e. payment of taxes and distribution of dividends out of capital respectively.
- Settlement of wage claims on time which companies cannot afford.
- Excessive taxation on the corporate sector in general and inequitable distribution of tax burden between companies.
- Investors are misled about the performance of companies.

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(v) **Difficulties in interpretation of financial statements:-**

(a) Under historical cost accounting, items in the income statement and balance sheet are recorded in units of different purchasing power. Figures of different dates representing different purchasing power are incomparable and incorrect. They blur real trends.

(b) The earnings capacity of the firm cannot be properly assessed due to difficulties in distinguishing between inventory profits or similar capital gains and the operating profits.

(c) If adjustments are made for reducing the reported profits, the ratio of adjusted profit on the revalued capital employed would be less than the ratio determined under historical costs.

(d) The return in real values on investment over a period of time falls with the increase in the annual rates of inflation. This will have an adverse impact on the quality of decision making by management.

Several broad social consequences may also follow. Corporate liquidity (debt paying ability) may also so low that it may bring an economic crisis. It may also lead to misallocation of resources, since allocation of resources is based in large part on financial statements. Overstatement of profits may lead to an unrecognised failure to maintain reasonable rates of capital formation. A nation with a declining rate of capital formation will find it difficult to maintain its relative position in a competitive world economy or to achieve a rising standard of living.

The impact of inflation on the financial operations of business firms has brought about dramatic changes in many established financial policies and practices. For example, the rate of interest on U.S. Government securities (called default free rate) consists of a 'real rate of interest' plus an inflation premium that reflects the expected long run rate of inflation. Accordingly, an increase in the rate of inflation is quickly translated into higher default free interest rates. The cost of money to firms is the default free rate plus a risk

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premium. Thus inflation induced increases in the default free rate are also reflected in business borrowing rates\(^5\).

Lenders also insist upon bonds whose interest rates vary with the general level of interest rates as measured by an index of interest rates. Brazil and other South American countries have used such index bonds for many a years.

**IMPACT OF INFLATION ON MANAGEMENT ACCOUNTING**

Much of the debate on inflation accounting has centred around external financial reporting. No emphasis has been laid on the provision of information for planning, decision-making and control. In fact, in the public debate, the impact of inflation on management accounting has been largely ignored. It has been argued that inflation accounting should be introduced throughout the whole of the management accounting structure before it is applied to the published accounts of an organisation.

The dynamic changes that have been occurring in the market in recent years have highlighted the need for systems of reporting product / market profitability and these require the use of current and future data\(^6\). Accounting figures adjusted to changes in price level will help in examining the impact of inflation on product profitability and analysing the worthwhileness of groups of products in relation to market shares and market growth rates. Analysis of actuals with budget and analysis of variances will help the management to examine the impact of high or low price levels than anticipated at the time of preparing budgets and significant controllable deviations from budget\(^7\). In recent years, most companies have developed dynamic and forward looking budgetary planning and control systems which require regular forecasting of future costs and inflation adjusted figures will provide a realistic starting point.

\(^7\) Ibid, P-165.
An important aspect, which is often overlooked is the appraisal of capital projects during inflation. The management accountant of an enterprise is generally responsible for the provision of information to assist managers in their decision making. If he ignores the impact of inflation on the information he is collecting, summarising and communicating to management, the decisions taken by those managers may not be optimal. Project appraisal under conditions of inflation is not a theoretically difficult task. But there are practical difficulties associated with the estimation of future cash flows from projects with lives of several years or more. The estimation of future cash flow is a complex problem when there is little or no inflation, but in the face of rapidly changing prices, it becomes more pronounced.

According to a study on investment appraisal practices used by British firms, investment was below the optimum level due to a common error in the treatment of inflation in the discounting models used by those firms. 'A large number of firms use a money target rate of return in association with cash flows estimated in current prices (with an added disadvantage of failure to predict the effects of differential, inflation as it affects their resources)'.

The money rate of interest which is also the market rate of interest includes an element of expected inflation whereas, future cash flows discounted with that rate does not include that element unless specific adjustment for anticipated inflation is made. The real rate of interest in inflationary conditions is significantly lower than the money rate and may even be negative. The former is obtained by converting the money rate by an index of inflation. The money rate is the product of the real rate and the rate of inflation and not their adjustment. Thus:

\[
1 + m = (1 +i) (1 + r) \quad \text{where,}
\]

\[m = \text{Money rate of interest}\]

\[i = \text{inflation rate}\]

\[r = \text{real rate of interest}\]
Correct capital budgeting decisions can be made either by computing the net present value by estimating future money cash inflows after specific adjustment for anticipated inflation and discounting them with the money rate of interest or by evaluating the net present value by estimating future cash inflows in real terms and discounting at the real rate of interest. Since different inflation rates can affect the desirability of an investment proposal, sensitivity analysis is useful in capital budgeting decisions for computing their impact on the projected cash flows.

CASE FOR INFLATION ACCOUNTING

Inflation accounting, which has become an important and constant fact of life in 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 likes Accounting for Prices Level Changes (APC), Price Level Accounting, Replacement Cost Accounting, Current Cost Accounting (CCA), General Purchasing Power Accounting (GPPA), etc. Research of the United States of America, the United Kingdom, Australia and Canada have given serious 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.

Thus the above discussion emphasises the importance and need for the introduction of inflation accounting in a firm for financial as well as management accounting purposes. It will enable the external users to assess the performance of the firm and on the other hand, it will enable the management to take optimal decisions.

REVIEW OF LITERATURE

A pioneering study in this field was undertaken by R.C. Jones way back in 1941-47. He surveyed nine U.S. Steel Companies and restated their financial statements to reflect changes in consumers price index (a proxy for an index of the general price level). Jones observed differences of substantial
magnitude in the results shown by conventional accounts and current purchasing power (CPP) accounts. Conventional accounts showed dividends being earned every year while CPP accounts did not show dividends in any year. Under conventional accounts income was retained to provide additional capital of $543 million unlike CPP accounts where dividends, interest and income taxes were paid out of capital to the tune of $409 million. CPP accounts showed an increase of 2% in working capital and a decline of 19% in fixed assets during the seven year period. On the other hand, conventional accounts showed an increase of 51% in working capital and a decline of 6% in fixed assets during the same period.¹⁰

Although the period during which this study was conducted coincided with the second world war and relatively high rates of inflation, subsequent studies have indicated that even in periods of moderate inflation, substantial differences exist.

A study of 30 large scale industries for 1947 and 50 large scale industries for 1948, undertaken by Cooper¹¹ led to the conclusion that profits would have been 20 per cent lower, had depreciation been calculated on replacement values. It was also argued that only current and future costs could have bearing upon managerial decisions and that the cost of goods sold based on current costs rather than original costs¹². Another study of twelve U.K. Companies was conducted by Pearcy¹³. He used the U.K. Consumer Price Index to restate the reported profits of these companies for the period 1958-68. Pearcy observed that over a period the aggregate net profits of the companies were overstated by approximately 10% and the retained profits by one-quarter. Furthermore, in 1968 the net profits after tax were overstated by 15%, the retained profits were overstated by 60% and the net of tax return on ordinary shareholders funds was overstated by 20%.

¹¹ Cooper, Howard, E. 'Depreciation on Current Values is Half as Much Again – An Experimental Determination'. N.A.C.A. BULLETIN (Sec.1), June 1950, PP, 1179-86.
The belief that account prepared on the basis of orthodox accounting concepts are dangerously misleading, has led to various proposals or modifications being put forward as an alternative. However, while some accountants take the view that presentation of meaningful accounts in times of inflation is necessary, there are others who have resented any proposal for reform. This resentment may spring from loyalty to professional doctrines and to some extent from the misplaced faith in the monetary unit. Some felt that accounting for changing prices or inflation accounting would actually tend to encourage inflation. 'In setting up the Sandilands Committee, the U.K Government delayed the introduction of an inflation accounting system and there was a belief that one reason was that the government felt uneasy that indexation in accounts might cause people to question the value of money, undermine the money illusions and enhance inflationary expectations at a time when it was felt necessary to restrain increases in prices and incomes.\(^{14}\)

There is no difficulty in perceiving the importance of inflation accounting, but the real difficulty arises when an objective and practical accounting method is to be developed. While the conventional accounting methods are objective and verifiable, measurements under inflation accounting seem to lack objectivity and are not easily verifiable but 'it is better to be vaguely true than to be precisely wrong.\(^{15}\) However, there is still a long way to go before inflation accounting is refined into a scientific and recognised technique.

Thus, Accounting for Changing Prices', or 'Inflation Accounting' has engaged the attention of accounting theoreticians and practitioners for many decades. A large volume of literature has been produced and several official pronouncements have been made on the subject but the debate still continues. Though an acceptable solution to this problem is yet to emerge, statements of concepts and standards suggesting the use of various methods to account for inflation, have been issued in a few countries. Noteworthy


among them are 'The International Accounting Standard' (IAS 15), issued by the International Accounting Standard Committee, 'Financial Accounting Standard 33' (FAS 33) issued by the Financial Accounting Standards Board (FASB) U.S.A, 'Statement of Standard Accounting Practice No. 16' (SSAP 16) issued by the Accounting Standards Committee, U.K. and the 'Statement No. 4510' issued by the Canadian Institute of Chartered Accountants.

The continuous price rise in the Indian economy, has also made 'Accounting for changing prices' imperative. Recognising the importance of the subject, the Research committee of The Institute of Chartered Accountants of India (ICAI) presented a discussion paper in February 1982, to generate discussion and create greater awareness about the subject. The paper pointed out that the main issue is to examine how and the extent to which inflation accounting techniques designed in western countries are applicable to the Indian situation.