CHAPTER - IV

INFLATION ACCOUNTING AND INTERNATIONAL SCENARIO
DEVELOPMENT OF INFLATION ACCOUNTING

Inflation Accounting is not a new field of study. Since the beginning of the twentieth century efforts have been made to adjust the accounts to reflect changes in price level. The approach taken by each country to inflation accounting is influenced by a number of factors. The urgency of the need to find a solution to the problem depends on the rate of inflation for an individual country. Thus, certain South American Countries with a traditionally high rate of inflation have been making adjustments to account for inflation while by contrast, in countries like Belgium and Germany, where the inflation rate has been comparatively low in recent years, there is little interest in inflation accounting. The sophistication of the regulatory environment for company reporting also influences the amount of interest in inflation accounting. Thus a number of proposals and recommendations have been issued in countries like U.K. and U.S.A., whereas in Italy no requirement or recommendation has been issued so far.

Developments relating to 'Inflation Accounting' in different countries, have been many and varied, we would like to discuss them in detail.

Germany

Germany contemplated the problem of price level adjustment as early as the 1920s due to the high rates of inflation after the World Wars. Schmalenbach, a distinguished German accounting theorist, commented on stabilised accounting in his book 'Dynamische Bilanz'. He pointed out that by 1920, managers (of firms following a policy of being a net monetary liability) realised that they would incur losses if there were occasional improvements in the inflationary situation. Therefore, they adopted 'measures of internal equalisation' whereby payments were made to prevent becoming a net monetary debtor. In this process purchasing power losses were compensated by purchasing power gains. Changes in working capital became the central

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component of financial statements. The accounting systems of firms became quite complicated.

By the end of 1923, the fall in the value of German mark reached great proportions giving rise to a number of accounting problems. Some German academicians suggested that replacement costs or adjustments based on individual business price index should be incorporated into financial reporting. Although replacement costs were used for day-to-day business, 'balance sheet stabilisation' in terms of the gold mark was used as a supplement to historical cost reporting. Each entry in the historical cost balance sheet was restated in terms of gold mark, assumed to have constant purchasing power and a change in its paper mark equivalent was assumed to represent a change in the purchasing power of the paper currency.

An accounting law, the 'Goldmarkbilanzgesetz' of 1924 attempted to improve the reliability of financial statements. However, with the introduction of the 'Rentenmark' towards the end of 1923 and the restoration of the gold mark in early 1924, the German economy eventually returned to a stable monetary unit and strict adherence to historical costs as the basis of accounting has been followed.

The military defeat and the economic consequences of the second world war led to a complete collapse of the German currency, the Reichsmark (RM). The situation was corrected by a monetary reform, the introduction of the Deutsche Mark (DM) in June 1948, the conversion ratio of RM for DM being 10:1, but it could not be applied to historical costs which were meaningless. A new law, the 'DM Eroffnungsbilanzgesetz' dated 21 August 1949 required all balances to be restated for financial reporting, including income tax accounting. All companies were required to prepare a Deutsche Mark opening balance-sheet on that date in order to provide a base point for future financial statements. The relevant legislation made the upper limit to valuation, 'Current Value' at the date of the balance sheet, but understatement was allowed. Depreciation was to be calculated on current
values\textsuperscript{3}. After 1948, the Companies Act and the commercial code returned to historical costs and the German laws found new ways to control prices.

In August 1975, the major committee (HFA) of the West German Institute (IDW) released its proposal, 'Accounting for Capital Maintenance in the Measurement of Company Profits', known as HFA 2/1975. The Institute proposed voluntary disclosure of estimated net amount of 'inflationary profits' (in a supplementary note or statement) which are included in the net income reported in the income statement.

In October 1975, a statement was issued by the committee of the German Institute of Chartered Accountants (Institute for Wirtschafts Priifer)\textsuperscript{4}. It recommended that the effect of changing prices on profits shown in the annual reports, should be indicated in supplementary notes, to produce a more realistic distributable profit figure. However, it did not require disclosure of restated balance sheet information. It may be pointed out that very few German concerns complied with the provisions.

France

The post 1919 inflation in France provided stimulus to a number of French accountants to consider the problems created due to the instability of the monetary unit. During the period 1919-27, the prices in France approximately doubled. The 'balance sheet stabilisation' method was followed.

Between 1930 when Poincare stabilised the value of the Franc and 1960, the French currency changed its official value 18 times and the government allowed firms to reflect these devaluations in their accounts. The taxation authorities took the first initiative through special concessions, rules of computation permitting firms to deduct something from their profits or composition of tax only on a part of profits or exemption of fictitious gains

\textsuperscript{3} Most, Kenneth, S., ACCOUNTING THEORY, Columbus, Ohio, Grid Inc., 1977, P-180.
\textsuperscript{4} Committee of the German Institute of chartered Accountants (Institute der Wirtschafts Priifer), 'Accounting for the purpose of maintaining the substantialistic value of an Enterprise, 175.
arising from the depreciation of the currency, thus permitting special reserves created to be capitalised.

A law passed in August 1945, authorised firms to revalue certain assets and its scope was widened until the measure enacted in December 1959. The law adopted the 'forfeitory method' for revaluation by applying an index of industrial wholesale prices, which permitted rapid calculation but also created problems. At the beginning of 1959, revaluation was still optional, could be partial and could not go further than the coefficients published by the Ministry of Finance. Revaluation of fixed assets had to be accompanied by a corresponding revaluation of provisions for depreciation.

A law passed in December 1959, laid down that revaluations were obligatory for all businesses (public and private) having an annual turnover during the previous three years of more than 500 million old francs and that they should be accomplished by December 1962. It affected 5000 firms. Two substantially different indices were used, one for fixed assets and depreciation and the other for stocks, shares and obligations.

In 1976, the government sponsored committee recommended that companies listed on the Stock Exchange should produce supplementary financial statements based on CPP principles. The government, however, did not accept this recommendation despite the legislation for revaluation of assets being operative in 1977 and 1978. The legislation which required revaluation of all long term assets at their use value to the enterprise at the end of 1976 was mandatory for listed companies but optional for all others. The revaluation law remained in force until 1979. Since then, revaluations have been permitted because the resulting surplus is taxable.\(^5\)

The French accounting profession has been slow to consider the impact of inflation upon accounts because the French have traditionally

prepared financial statements for tax purposes. The Government and the committee des operations de Bourse (the French equivalent to the US Securities and Exchange Commission) started taking an interest on the impact of inflation. Consequently in 1981, an Exposure Draft was issued, suggesting an inflation accounting approach based on a general price index has been developed.

Holland (Netherlands)

During the 1920s, a new production theory of value was constructed by a Dutch accounting professor, Theo Limperg, which later came to be known as the Replacement Value Theory. The significance of the replacement value theory arises from the Limpergian view that the economic function of management is to take economic decisions relating to production, quantities and prices. Financial accounting is then viewed as a subset of management accounting. In that financial decisions are the consequences of production decisions; to take rational decisions, the manager must at all times know the value of what he must use to produce or what he must give up to replace, that which he sells. This involves continuous updating of historical values to current input values and also the calculation of the effects of price level changes on working capital requirements.

Another advocate of current replacement value accounting in the Netherlands was Goudeket (The replacement value theory has been discussed in details in chapter III). During the Great Depression, characterised by deflation, the logic of replacement value implied writing down the historical costs of equipment and inventories to their lower current values. Several Dutch companies adopted replacement value accounting and prospered. Notable among them was the multinational electronics giant Philips Gloeilampenfabrieken N.V., one of the world’s largest companies. In case of a significant price change, the appropriate asset account was adjusted to replacement value and the difference was credited to an asset surplus revaluation account. All current assets except inventories less total

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liabilities were adjusted by the application of a general cost of living index. Philips charged the loss in purchasing power of these items to 'cost of inflation'. Stock appreciation was excluded from profit.

Although Philips followed replacement value accounting, all Dutch companies did not adopt the same. In 1971 only 28 out of 129 companies with securities quoted on the Amsterdam Stock Exchange prepared financial statements based on replacement value accounting. Dutch-register accountant, Jules W. Muis stressed that in Netherlands, Current Value Accounting was being practised by few companies who were using their own techniques with varying degrees of thoroughness7.

The debate over the Act on Annual Accounts of Enterprises proposed in 1971, led to the formation of the 'Tripartite Study Group' to determine acceptable accounting standards. The group comprised of representatives of employers, unions and Netherlands Institute Van Register Accountants (NIVRA)8.

South Africa

In January 1975, the National Council of Chartered Accountants in South Africa issued a discussion paper entitled "Accounting for Inflation and other changes in Price Level". The recommendations were similar to the Current Purchasing Power Approach. In October 1975, a circular was issued that accountants should experiment with various inflation accounting techniques.

Japan and other Asian Countries

L.G. Campbell in his article "Current Accounting Practices in Japan" has discussed the practice followed by Japanese Companies in respect of some major aspects of financial accounting and reporting. None of the companies surveyed gave any form of inflation adjusted accounting

information nor was there any legal or professional requirement to publish such information. In fact, the Business Accounting Deliberation Council of Japan regarded historical cost accounting preferable to any form of inflation accounting. However, there is a requirement for disclosure of cash flow information in supplementary schedules filed with the Ministry of Finance.

Other Asian countries like Indonesia, Korea etc. have started taking keen interest in Inflation Accounting and introduced legislation which allows depreciation to be based on inflation adjusted fixed asset values. However, no formal pronouncements have been issued in these countries.

Israel

A study of 19 industrial firms\(^9\) listed on the Tel Aviv Stock Exchange was conducted and their Annual Reports (1968-1974) were restated on the basis of recommendations of the Institute of Certified Public Accountants, Israel, SSAP 7 and the AICPA's APB Statement No. 3. An analysis of reported profits after tax incidence of corporate income tax and dividend cover led to the conclusion that the adjusted income is less than nominal earnings even after the inclusion of monetary gains and that taxes and dividends are sometimes not covered by adjusted profits.

Brazil

Brazil experienced extremely high rates of inflation for many years. In 1964, inflation accounting was introduced into tax laws by the government. A system of monetary correction known as 'indexing' was adopted as the basis of financial reporting.

The nominal amounts of assets and liabilities were adjusted by the use of a purchasing power index, interest being paid on the higher amount. The monetary correction was tax free. Fixed assets were restated annually and depreciation was calculated on the restated amounts, the increase in asset amount being credited to capital. A provision for 'maintenance of stockholders

investment' charged to the income statement on all assets and liabilities (except fixed assets) was tax-deductable and included the monetary correction adjustment. Inventories were treated as monetary assets, because firms corrected the amount in accordance with purchasing power changes.\(^\text{10}\).

The provisions of the Brazilian Corporation Law (Law No. 6404 of December 15, 1976) to be effective for financial years beginning after January 1, 1978, set out a different standard of accounting and financial reporting, although the generally accepted accounting principles were maintained.\(^\text{11}\) Faced with double and triple digit inflation, the Brazilian Corporation Law now requires two adjustments for reporting and tax purposes. Fixed assets should be compulsorily adjusted at the end of each financial year on the basis of changes in Government Wholesale Price Index and depreciation should be based on the restated asset figures. Second adjustment, which relates to working capital items requires an allowance for maintenance of the purchasing power of stocks and net monetary items. The Brazilian Government Treasury Bond Index (ORTN)\(^*\) is to be used as deflator and the stipulated adjustments be made in the income statement and balance sheet. The revised profit figure is accepted for tax purposes.

**Argentina**

The Argentina accounting profession has been actively involved in the development of inflation accounting proposals. In 1972, the Argentina Federation of Accountants issued a statement 'Dictamen No. 2' which recommended the presentation of supplementary general purchasing power statements by business enterprises from 1972 onwards to eventually replace historical cost information. But the rate of compliance was poor due to lack of government support.

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\(^{11}\) Manoel Riberio da Cruz Fillo & Amandio da Silva Machado, 'Accounting for inflation: Brazil', FINANCIAL EXECUTIVE, December 1978, P-42.

* ORTN – Index Published by Government based on bond redemption rate and used as a monetary unit to express the updated value of Brazil’s Currency.
The peron Government introduced the Social Contract in 1973, in which price controls were the key component of the programme. In September 1980, the Argentina Professional Council of Economic Sciences of the Federal District, which regulates the public accounting profession in Beunos Aires declared that in future the basic financial statements should disclose historical cost constant dollar figures in one column and historical cost figures in another.

Chile

Due to the high rates of inflation, the accountancy profession tried to introduce an inflation accounting system which found little government support. In 1975, chile however became the first country to adopt a comprehensive General Purchasing Power Accounting System for financial reporting and taxation purposes. Although similar to U.S. proposals on the subject, stocks were frequently valued at replacement costs.

Uruguay

In Uruguay, revaluation became a generally accepted accounting principle and if a company did not revalue, the auditors commented on it in their report.

Official indices were published for revaluation and depreciation was calculated on the revalued amounts for taxation purposes.

Australia

During the period 1950-70, several contributions to the theory of accounting for changing prices were made by Australians. Noteworthy among them were 'adjustments to exit values recommended by chambers, 'replacement cost accounting' favoured by Mathews and a 'replacement cost approach' using specific indices recommended by Gynther who identified assumptions and analysed alternatives\(^\text{12}\).

\(^{12}\) Most, K.S., ACCOUNTING THEORY, OP., Cit., P-187.
In December 1974, a joint committee of the Institute of Chartered Accountants in Australia (ICAA) and the Australian Society of Accountants (ASA), i.e. the Australian Accounting Standards Committee (AASC) issued an exposure draft entitled ‘A method of Accounting for Changes in the Purchasing Power of Money’. Its contents were similar to PSSAP 7 of U.K. (discussed later). In November 1974, the government appointed an enquiry group called Mathews Committee to study the effects of inflation primarily upon taxation. The Mathews report supported Current Value Accounting but failed to recognise the gains arising from long term borrowing during a period of inflation.

In June 1975, the AASC issued another exposure draft ‘Current Value Accounting’. It recommended the adoption of current value accounting to maintain the operating capability of an enterprise. It also bore evidence of Gynther’s analytical work, starting with a statement of deficiencies of historical cost accounts and also stated the three alternatives: GPP accounting, replacement cost accounting and a combination of the two. However, it did not recognise purchasing power gains and losses on holding monetary assets and liabilities because of implementation problems. Changes in the replacement costs of non-monetary items where regarded as restatements of capital, hence they did not affect the income statement.

Impressed by the Sandilands Committee recommendations in U.K., the AASC issued a Provisional Standard on ‘Current cost Accounting’ in October 1976. Later a steering Group was formed. It prepared a revised recommendation that current cost of fixed assets, depreciation, inventories and cost of sales should be disclosed in supplementary notes, to be effective.

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from July, 1978. But the provisional standard did not cover gains and losses on holding monetary items. As a result an Exposure Draft: 'The Recognition of Gains and losses in Holding Monetary Items in the context of Current Cost Accounting' was issued in August 1979.

A proposed standard issued by the Australian Current Cost Accounting Standards Committee of the Australian Accounting Research Foundation provided that from 1983, all listed companies with total assets exceeding 20 million Australian dollars should present supplementary income statement and balance sheet reflecting current cost adjustments for depreciation, cost of sales and gains or losses on monetary items instead of that it was observed that, inflation accounting has been losing popularity in the last few years.

Two leading Australian Companies the Broven Hill proprietary (BHP) and the CSR have abandoned inflation adjustments presented as supplementary information, on the ground, that it is not relevant and is ignored by most analysts. A para in the CSR’s published accounts read “The company will not play the game in future unless everybody else does, especially the tax authorities”.

New Zealand

The New Zealand Society of Accountants is the leading professional accounting group in the country. In December 1974, it issued an Exposure Draft 'Accounting for changes in the purchasing power of money, recommending the general purchasing power approach which did not receive much support. In March 1975, another Exposure Draft, ED-10 was published by the society based on UK’s PSSAP-7, but was later withdrawn.

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The next exposure Draft, ED-14, published by the society, entitled 'Accounting in terms of Current Cost and Values'\textsuperscript{20} recommended a Current Cost System similar to the recommendations of the Sandilands Committee but was later withdrawn. In December 1975, the Government established a Committee of Enquiry into Inflation Accounting under the chairmanship of I.L.M. Richardson, which submitted its report in September 1976\textsuperscript{21}. The report recommended the adoption of financial statements based on Current Cost Accounting instead of historical costs based financial statements, valuation of assets at current costs to the enterprise, profit to be measured according to operating capability concept of capital maintenance and the adoption of gearing adjustment. In the later part of 1975, the Department of Management Studies at the University of Waikato initiated an Inflation Accounting Research Project (IARP). A Working Manual was published under the IARP at the request of the New Zealand Society of Accountants\textsuperscript{22}.

After a comprehensive study of various proposals and discussions thereupon, a final standard entitled 'Current Cost Accounting- No. 1' was submitted to the Council of the New Zealand Society of Accountants. The standard issued in March 1982 and similar to standards in other commonwealth countries, requires listed companies to present supplementary current cost information and stipulates three adjustments, namely depreciation, cost of sales and monetary working capital adjustment to historical cost based operating income to arrive at current operating profit.

Canada

The Canadian accounting profession has been influenced by developments in U.K. and U.S.A. The Canadian Institute of Chartered Accountants (CICA) published a discussion paper 'Current Value Accounting and Price Level Restatements', in 1971. The paper recommended retention of

\textsuperscript{20} New Zealand society of Accountants, 'Accounting in terms of Current Cost and Values, Exposure Draft-14, of Proposed Statement of Standard Accounting practice (Willington, New Zealand, August, 1976).


\textsuperscript{22} Inflation Accounting Research Project, CCA Working Manual (Department of Management Studies, University of Waikato, Hamilton, New Zealand, March 1979).
historical costs in published accounts but stressed the need to reflect price level changes in financial reports. Specific price changes were preferred.

The Accounting Research Committee of CICA released in November 1974, guidelines titled 'Accounting for the Effects of Changes in General Purchasing Power of Money'. It suggested optional publication of supplementary general price level adjusted statements. In July 1975, these guidelines were re-issued as an Exposure Draft 'Accounting for Changes in the Purchasing Power of Money'. This was followed by a detailed 96 page discussion paper drafted by the Accounting Research Committee in August 1976 on 'Current Value Accounting'. The paper recommended the use of current replacement costs for fixed assets and inventory and valuation based on discounted cash flow for monetary items. Recommendation for disclosure of the effects of inflation on business was also made by a committee appointed by the province of Ontario in June 1977.

In December 1982, the CICA, issued the Canadian Accounting Standard 'Reporting the Effects of Changing Prices in the supplementary information section 4510 of the CICA Handbook. The Standard bears resemblance and appears to be a combination of SSAP 16 (U.K.) and FAS 33 (U.S.A). It requires large publicly held companies having fixed assets and inventories worth 50 million Canadian dollars or total assets worth at least 350 million Canadian dollars to disclose supplementary current cost information on certain items (for which the effects of changing prices of changing prices are likely to be significant) in their annual reports for years commencing on or after January 1, 1983.

The Standard requires the disclosure of
(a) the current cost of inventories and of property, plant and equipment at the end of the reporting period,

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(b) the current year's increase or decrease in the current cost of inventories and of property, plant and equipment,
(c) the net assets of the enterprise after restating inventories and property, plant and equipment at the end of the reporting period;
(d) the amount of current cost income or loss after reflecting the cost of sales and depreciation, depletion and amortisation of property, plant and equipment on a current cost basis.

The Standard enables users to compute the income attributable to shareholders under the financial concept and operating capability concept of capital maintenance. The implementation of the standard was to be monitored and a comprehensive review was to be undertaken in 5 years time.

The Canadian Business Corporation Act and other provincial Acts require that financial statements should be prepared in accordance with the CICA handbook, thus granting legitimacy to the standard. However, it was evident during the first year of disclosure that companies were unwilling to accept the recommendations of the Standard due to declining rate of inflation, lack of demand from investors and difficulties in interpreting the information presented.

U.S.A.

The instability of the dollar during the period 1897-1917 encouraged Middleditch to question - "should accounts reflect the changing value of the dollar?" He proposed adjusting all year and balances using index numbers, to reflect some stable measurement unit. But this proposal was not received favourably by the accounting professionals. Paton, an eminent accounting theorist of the twentieth century regarded index numbers as unreliable and, therefore, suggested writing up of fixed assets to their replacement cost and calculating depreciation on the revised value. He pointed out that certain long standing theories and policies of accountants should undergo modifications if

the purposes of the various interests in the business enterprises are to be adequately served\textsuperscript{28}. The response to his proposal was lukewarm. In 1936, Sweeney published a book in which he demonstrated a method of stabilising either historical costs or replacement costs by adjustments for price level movements using the purchasing power of money as the basis of stabilisation\textsuperscript{29}. His proposal was an extension of the German gold mark stabilisation.

A characteristic feature of the postwar period was the involvement of professional bodies and the government in studying the impact of inflation, consideration being given to general price level adjustments. Research was encouraged and in some instances sponsored by professional bodies, especially by the American Accounting Association (AAA). In 1947, the American Institute of Certified Public Accountants (AICPA) set up a Study Group, to study the concepts and terminology of business income. The Study Group concluded in its report entitled 'Changing Concepts of Business Income' (1952) that '............... corporations whose ownership is widely distributed should be encouraged to furnish information that will facilitate to determination of income measured in units of approximately equal purchasing power\textsuperscript{30}. George O. May, a member of the above mentioned Study Group, published a monograph recommending price level adjustment to two items, inventory and depreciation\textsuperscript{31}. Among the various research studies conducted in the 1950s, Hendrikson's case study of two public utility firms and Jones influential case study of four steel companies are worth mentioning\textsuperscript{32}.

In the 1960s the Research Division of AICPA was issued a directive by the Accounting Principles Board (APB), 'to set up a research project to study

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the problem and prepare a report recommending disclosure of the effects of price level changes upon financial statements'. It resulted in the Publication of Accounting Research Study No.6 (ARS 6), 'Reporting the Financial Effect of Price Level Changes' in 1963 33. It recommended that differences resulting from inflationary or deflationary price level changes of non-monetary assets be eliminated by using the GNP deflator and that the general purchasing power gains or losses on monetary assets and liabilities should be reported in the income statement before showing changes in retained earnings. APB decided to conduct a field test before committing itself on the proposal. 18 companies listed on the stock exchanges were asked to restate their financial statements for the years 1966 and 1967, as proposed by the study. It concluded that there was a general agreement among participants that with proper preparation, practical problems would not impede the presentation of general price level financial statements34.

In 1969, the APB issued its statement No. 335 'Financial Statements Restated for General Price Level Changes'. It recommended the presentation of price level adjusted financial statements accompanied by explanations as a supplement to historical cost financial statements. Monetary items had to be distinguished from non-monetary items and GPL gains and losses had to be reported separately in the GPL income statements. Since the publication of such supplementary information was optional it had little impact on the generally accepted accounting practices in U.S.A. Indiana Telephone Corporation was the only company which published historical and GPL financial statements side by side.

The accelerated rate of inflation in 1973 led the Financial Accounting Standards Advisory Council to urge the Financial Accounting Standards Board (FASB) to consider the problem of accounting for price level changes. FASB published a discussion memorandum in February 1974, reaffirming

statement No. 3. Around the same time, the Trouble-hood report stated that the objectives of financial statements could not be served by the exclusive use of a single valuation basis. It recommended the use of historical costs, exit values, current replacement costs and present values in the basic statements. However, in December 1974, FASB issued an exposure draft 'Financial Reporting in Units of General Purchasing Power' (Proposed Statement of Financial Accounting Standards) which endorsed ARS 6 and APB statement No. 3 and proposed to require supplementary GPL financial statements for fiscal years beginning on or after January 1976. The Exposure Draft also discussed in detail the classification of all assets and liabilities into monetary and non-monetary items.

In March 1976, the Securities and Exchange Commission issued Accounting Series Release No. 190 (ASR 190): 'Notice of adoption of amendment to regulation S-X requiring disclosure of certain replacement cost data'. It required the disclosure of cost of goods sold at current replacement cost and of depreciation on the basis of current cost of replacing productive capacity. It did not help users to convert the data into a single revised income figure; instead it lay emphasis on information that would assist in understanding the current economies of the business. It was criticized by the accounting fraternity both on conceptual and practical grounds. It would enable manipulation of figures. It was viewed as, "hastily rammed through without research and premised on hypothetical future replacement rather than on equipment in use"36.

In December 1978, the FASB issued an Exposure Draft entitled 'Financial Reporting and Changing Prices'. In March 1979 it issued another exposure draft entitled 'Constant Dollar Accounting' as a supplement to the 1974 proposed statement on general purchasing power adjustments. These exposure drafts were general in nature and their exposure period ended on 1


FAS 33 applied to certain public enterprises whose primary financial statements at the beginning of the fiscal year showed either:

(i) Inventories and gross fixed assets (excluding intangible assets) exceeding $125 million, or
(ii) Total assets (after deducting accumulated depreciation) exceeding $1 billion.

The statement did not require any change in the primary historical cost financial statements. The supplementary information required by the statement relates to the effects of changes in general level prices (HC / Constant dollar information) and in the prices of specific assets (current cost information). Disclosure requirements were limited to supplementary information on income from continuing operations for the current fiscal year, a five year information summary and certain other supplementary data for the latest year and the five most recent years. The requirements were effective for financial statements issued after 24 December 1979 with a one year delay of the current cost requirements if a reporting company had difficulty in implementing the requirements more quickly. The supplemental information to be presented included:

(i) income from continuing operations adjusted for general price level changes
(ii) the general purchasing power gain or loss (called gain from decline in purchasing power of net amounts owed) though it is not included in the calculation of income (Loss) from continuing operations
(iii) income from continuing operations on a current cost basis
(iv) current cost of inventory at the end of the year
(v) current cost of property, plant and equipment at the end of the year

the increase or decrease in the current cost of inventory, property, plant and equipment, net of general price level changes

a ten-year summary of selected financial data.

Restatement was required only for inventory, fixed assets, cost of goods sold and depreciation, depletion and amortization expenses on the ground that differences between the restated amount and historical cost are likely to be particularly significant for those items. The statement, however, encouraged enterprises to present financial information based on comprehensive restatement.

The statement discussed several important issues relating to its objectives:

- it required that assets stated at current costs should not be valued in excess of net realisable value or value-in-use (recoverable amounts). Due to the difficulty in estimating value in use, the statement required a write down to value-in-use only if the amount was materially and permanently lower. It also permitted grouping of assets to determine whether a write down was necessary.

- it recognised the circumstances in which a company's depreciation methods and estimates of useful lives and salvage values take inflation into account. Therefore, it permitted the use of different methods and estimates for restating depreciation on current cost basis and on historical cost / constant dollar basis.

- it contained a number of provisions recognising the special problems of particular industries such as banks and insurance companies, long-term contracts, natural resources and real estate.

The statement enables users to take economic decisions, assess the cash flow of the enterprise and understand the effect of inflation on accounts. However, the requirement of information based on constant dollars and current cost approach may be interpreted as a failure on the part of FASB to

choose between the two most common methods of inflation accounting. Donald Kirk, Chairman of FASB pointed out that more evidence was needed before deciding which is preferable and that the market place was an important factor in that decision. Further, certain provisions in the statement may lead to controversial problems: provisions relating to current cost / constant dollar basis, subjective nature of determining value-in-use, different procedures of writing down if current costs are in excess of net realisable value, multinational corporations and their subsidiaries, IRS position, inventory gains or losses and partial restatement basis Vs. comprehensive basis\textsuperscript{39}.

An Advisory Board was organised to develop and publish illustrative disclosures providing guidelines to firms. About 1200 corporations were to be affected by FAS 33. It was expected to have a significant impact, especially in areas of auditing and management advisory services. A number of research projects were initiated by FASB to collect data and monitor the implementation procedures. In January 1983, FASB held a conference of researchers; financial analysts and Practising Certified Public Accountants to evaluate the results. It was found that historical cost earnings reflected in detail, changes in stock prices, as compared to FAS 33. Also current cost data was preferred by financial analysts, as it seemed effective in forecasting dividends of public corporations. It also increased the awareness of the management to the effects of price level changes. Further FAS 33 data was not effective in identifying investment takeover targets\textsuperscript{40}.

In December 1983, FASB issued the invitation to comment (IC) ‘Supplementary Disclosures about the Effects of changing prices’. IC invited views on whether changing prices disclosure should be continued and if it should be so, the potential amendments to FAS 33. Although inflation had declined, discussions in IC generally favoured disclosure, because the effects of inflation would be manifested after many years and therefore long term

series of observations would be useful. Moreover, if disclosure was suspended, the costs of reviving such disclosures, if necessary, in future, would be substantial.

As far as disclosure was concerned, there were three options:-

(i) Companies with significant amounts of inventory and fixed assets should disclose current cost data whereas others may disclose constant dollar data.

(ii) Companies with significant amounts of inventory and fixed assets should disclose current cost data whereas for other companies disclosure requirements should be rescinded.

(iii) Companies should disclose only constant dollar data. However, constant dollar data was not very useful and hence was not favoured.

In November 1984, FASB issued SFAS-82, "Financial Reporting and Changing Prices: Estimation of Certain Disclosures". SFAS-82 attempts to modify certain supplementary disclosure requirements contained in SFAS-33. Historical cost constant dollar disclosure requirement was eliminated because FASB believes that requiring two different methods of reporting the effects of changing prices detracts from the usefulness of the information. Further it would reduce the costs that the companies would have to incur in preparing the data.

United Kingdom (U.K.)

In U.K., interest in inflation accounting was restricted to the implications for taxation policy and depreciation provision. However, the monetary inflation in the late 40s and early 50s in U.K., prompted professional bodies to support financial statements reflecting changes in the prices of specific items. In January 1949, the Institute of Chartered Accountants in England and Wales (ICAEW) published a recommendation on accounting principle No. N-12 entitled 'Rising Price Level in Relation to the Accounts'. Although it was the first time that the inflation problem of accounts was recognised, the

recommendation merely stated that amounts should be set aside to meet the cost of assets. Replacement was to be treated as a specific capital reserve rather than as depreciation.

In May 1952, ICAEW issued another recommendation 'Accounting in Relation to changes in the purchasing power of money'. During the same year, the Association of Certified and Corporate Accountants published 'Accounting for inflation' and the Institute of Cost and Works Accountants published 'Accounting for Changing Price Levels'. These books were merely reports of research committees, not official expressions of the respective bodies. In 1955, the Royal Commission on Taxation of Profits and Income also recognised the problem but did not make any specific recommendations.

In 1968, the research committee of ICAEW sponsored the publication of an inflation accounting booklet: 'Accounting for Stewardship in a period of Inflation' which favoured adjustments for changes in price level. In a subsequent discussion paper, 'Inflation and Accounts' – Discussion paper and Fact Sheet (1971), the Accounting Standards Steering Committee (ASSC), expressed its support for general price level adjustments.

In January 1973, the ASSC issued Exposure Draft No. 8 'Accounting for Changes in the Purchasing Power of Money', by for the most definitive proposal on inflation accounting. It proposed a system of current purchasing power to be presented as a supplement to historical cost financial statements incorporating both the balance sheet and the income statement, using preferably the consumer price index to avoid wide divergence between historical cost figures and inflation-adjusted figures. Reactions among the accounting profession and the business community were many and varied. It was criticised on the grounds that the general price level index is not relevant to the price movements of individual company's assets, and that the inclusion of monetary gains and losses in earnings would give a misleading picture.

about the financial state of an enterprise. At the same time, it was welcomed by many; particularly the ‘Confederation of British Industries’.

Amid the discussion and general interest in inflation accounting the government announced its intention of forming a committee with wide terms of reference, to review the accounting implications of inflation. The committee popularly known as the Sandilands Committee, submitted its report in June 1975. It suggested Current Cost Accounting (CCA) as a base for financial reporting in preference to Current Purchasing Power (CPP) Accounting or Replacement Cost Accounting. The committee regarded CCA as an evolutionary and comprehensive method of accounting for inflation. The main features of the CCA principles as recommended by the committee are:

(i) Money is the unit of measurement.
(ii) Assets and liabilities are shown in the Balance Sheet at a valuation.
(iii) Operating profit is struck after charging the ‘value to the business’ of assets consumed during the period, thus excluding holding gains from profits and showing them separately.
(iv) Purchasing power gains and losses should not be treated as profits because when the accounts are drawn up in terms of monetary units, no gains or losses in terms of money can arise through holding monetary items when prices are changing.

In order to reflect the ‘value to the business’ of assets consumed, two adjustments to the historical cost income statement viz. Cost of Sales Adjustment and Depreciation Adjustment were recommended by the committee.

(i) Cost of Sales Adjustment (COSA) – CCA requires that the amount charged to the income statement as cost of sales should reflect the ‘value to the business’ of stock consumed during the year. However, in view of the practical problems involved in ascertaining precisely the current cost of stocks consumed, the committee recommended that a

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45 Sandilands, OP. Cit., Para 537, P-163.
cost of sales adjustment should be computed and added to the conventional figure of cost of sales. The 'averaging method' was suggested by the committee for calculating COSA.

(ii) Depreciation Adjustment – CCA also requires that the amount of depreciation charged to the income statement should reflect the 'value to the business' of assets consumed during the year. The committee recommended the computation of depreciation charges on the basis of year end values of assets\textsuperscript{46}, in view of the practical difficulties involved in computation on the basis of average current values of assets during the year. The committee further rejected the need to charge backlog depreciation in the income statement.

Other important suggestions made by the committee were:

(i) An initial standard of CCA should be made mandatory.

(ii) A Steering Group should be set up under the aegis of the ASSC to oversee the introduction of CCA.

(iii) Professional accounting bodies in consultation with ASSC and the Steering Group should make interim recommendations to their members on how the effects of costs and prices should be shown during this period.

While the Sandilands Committee was undertaking its work, the ASSC issued a Provisional Statement of Standard Accounting practice No. 7 (PSSAP 7) in May 1974\textsuperscript{47}. The main requirements of PSSAP 7 were as follows:-

(i) It was a provisional standard, not binding in its effect but strongly recommended by Accounting Standards Committee member bodies.

(ii) It applied specifically to published annual accounts of stock exchange listed companies.

(iii) It provided that companies should incorporate some element of asset valuation as their main accounts. In addition, they should include supplementary statements adjusted to changes in the purchasing

\footnotesize{\textsuperscript{46} Sandilands Committee Report, Op., Cit., Para 109, P-186.}

\footnotesize{\textsuperscript{47} ASSC, 'Accounting for Changes in the Purchasing Power of Money', PSSAP 7, ICAEW London, May 1974.}
power of the pound using the Retail Price Index. Previous year’s figures also had to be ‘updated’.

(iv) Monetary gains or losses including gains on long-term borrowings were to be treated as a part of profit for the year.

PSSAP 7 came in for criticism due to the practical difficulties in applying it. A number of items like deferred taxation, convertible debentures etc. could not be classified within the terms of definitions given by, PSSAP 7. It did not define ‘Value to the business’. It did not recommend the symbol to be used to denote the CPP unit except that it should be a monetary unit symbol. It was also argued that long-term monetary gains should be taken directly to reserves instead of being taken through the income statement. It accepted approximations in supplementary statements and the cost of compliance was substantial. Presentation of CPP accounts as supplementary statements was criticised on the grounds that it played down their significance enabling outside pressures to reject the CPP approach. The ASC only laid emphasis on presentation of CPP accounts without prescribing details relating to the form and content of CPP statements. The 1975, ‘Survey of published Accounts’ found that only 48 out of 300 listed companies Published a full CPP statement.

The Sandilands Report, on the other hand enjoyed widespread acceptance for various reasons. Firstly, the full and detailed argument of the report commanded widespread respect. Secondly, there was a belief that the need for action was so urgent that whatever the merits of alternative approaches, it was desirable to proceed with the system commanding most respect. And finally, it was likely to be accepted for regulatory purposes in view of the government support for the Report.

The Consultative Committee of Accounting Bodies accepted the CCA system (Proposed by the Sandilands committee) for non-monetary assets but regarded it as inadequate to deal with the decrease in the value of monetary assets and liabilities or with the effect of inflation on the value of the
proprietor's interest in the firm. In response to the Sandilands Report, the accounting profession set up the Inflation Accounting Steering Group (IASG) under the Chairmanship of Mr. D.S. Morpeth to develop an exposure draft on CCA. The result was issued on November 1976 as ED 18, the most substantial exposure draft, running to 107 pages and containing a detailed proposal for the implementation of a CCA system. It presented five major improvements over historical cost accounts:

(i) Depreciation should be calculated on 'value to the business' of assets concerned.
(ii) Cost of sales should be calculated on cost of replacing goods sold.
(iii) A new statement: 'The Appropriation Account' should bring together the current cost profit, revaluation surplus, the amount appropriated by directors to or from revaluation reserve, dividends for the year and balance transferred to or from general reserve.
(iv) The balance sheet should show assets at current values.
(v) The statement of change in the amount attributable to ordinary shareholders after allowing for change in the value of money will show the performance of the company in relation to inflation and should also show the loss or gain on holding monetary items; operating profit and extra-ordinary items would appear in the profit and loss account and holding gains or losses in the profit and loss appropriation account.

Critics of the ED 18 approach argued that it was too complex, the cost of compliance was substantial, its time table was too rapid. Particularly in view of the need for international harmonisation, and that it was trying to achieve too much, too quickly. In a period when corporate morality and responsibility were going down, the directors were left with considerable discretion in choosing the basis on which transfer to or from revaluation reserve would be made. Treatment of overseas assets and liabilities was inadequate especially in view of the investments and operations of British companies in foreign


countries. Further, the presentation of accounts on CCA basis was too complicated for interfirm and inter-period comparisons. Smaller companies would have difficulty in implementing ED 18.

In response to the criticism of the Morpeth Proposals, the ASG announced that the proposal would be simplified and subjected to further debate. In June 1977, at a special meeting of ICAEW, the members voted for a resolution (in ratio of 54:46), against maning CCA mandatory inspite of the Institutes' council reaffirming its support to CCA.

Following the rejection of ED 18, the ASC issued 'Inflation Accounting': An Interim Recommendation\(^{50}\) in November 1977, referred to as Hyde Guidelines after the Chairman of the committee which produced it and applying to listed companies. It suggested the publication of current cost statement, in the accounts, showing the effect of three current cost adjustments on historical cost profit:

(i) Depreciation Adjustment for the difference between historical cost and current cost depreciation.

(ii) Cost of Sales Adjustment (COSA) for the difference between current cost and historical cost of stock at the point of sale.

(iii) Gearing Adjustment to reflect the effect of holding monetary items. Where the company had not monetary liabilities, the gearing adjustment consisted of a reduction in CCA adjustments reflecting the extent to which the operating capability of the business was financed by borrowing. The gearing adjustment was computed by the formula:

\[
\frac{\text{Net monetary liabilities}}{\text{Equity + Net Monetary Liabilities}} \times (\text{Depreciation adjustment} + \text{COSA}).
\]

Where the company had net monetary assets, the gearing adjustment was to reflect the increase in monetary assets needed to maintain its scale of operation.

\(^{50}\) Accounting standards Committee, 'Inflation Accounting : An Interim Recommendation' by the ASC, London, ICAEW, November 1977.
The formula was:

\[
\text{Net monetary assets} \times \frac{\text{Closing-opening 'appropriate' Index}}{\text{opening 'appropriate' Index}}
\]

In either case, the gearing adjustment would be based on the average of opening and closing balance sheet values taking into account by CCA revaluation surpluses on fixed assets and stock. Despite the crudeness of the gearing adjustment, the interim guidelines were welcomed as a workable step towards a more comprehensive system of CCA.

In April 1979, the Morpeth group issued an exposure draft, Ed 24\textsuperscript{51}, a brief document which contained a statement of principles and the disclosure requirements of the system of CCA it proposed. ED 24 proposed that listed companies and all other companies with a turnover exceeding £5,000,000 per year should be required to present supplementary current cost accounts. It recommended a monetary working capital adjustment (MWCA) in addition to the depreciation adjustment, COSA and gearing adjustment. MWCA would reflect the amount of additional (or reduced) finance needed for monetary working capital as a result of change in input prices of goods and services, following logically from the traditional capital maintenance theory. To limit the subjectivity involved in defining items to be included in monetary working capital, ED 24 required that it be based on trade debtors and trade credits. MWCA complements COSA and together they allow for the impact of price changes on the total amount of working capital used by the business in its day-to-day operations. Further more ED 24 went a step ahead than Hyde Guidelines as it required listed companies to disclose the current cost earnings per share and to include a current cost balance sheet in the current cost accounts.

Various recommendations were made to ASC on ED 24. It was argued that if monetary working capital requirements justified MWCA, then similar adjustments should be made for other factors leading to the same result e.g.

increase in the credit period allowed to customers. The exclusion of cash and bank balances from the ambit of MWCA did not have any justification. It made no provision to show real holding gains of the business. However, ED 24 was relatively free from most of the criticism levelled against ED 18 except some finer points of detail that remained to be worked out.

In March 1980, the Statement of Standard Accounting Practice No. 16 (SSAP 16)\textsuperscript{52} was issued. SSAP 16 stated that, the basic objective of current cost accounts is to provide more useful information than that available form historical cost accounts alone for the guidance of the management of the business, the shareholders and others on such matters as:

(ii) the financial viability of the business
(iii) return of investment
(iv) pricing policy, cost control and distribution decisions
(v) gearing\textsuperscript{53}.

The current cost operating profit is derived in two stages. In the first stage the current cost operating profit is determined after making three adjustments to historical cost trading profit (before interest on net borrowings). These are:

(ii) Depreciation Adjustment
(iii) Cost of Sales Adjustment (COSA)
(iv) Monetary Working Capital Adjustments (MWCA).

These three adjustments would help to maintain the firm's operating capability. In the second stage the current cost operating profit attributable to shareholders is determined i.e. if net operating assets are partly financed by external borrowings, then a fourth adjustment is made.

(v) Gearing Adjustment: This adjustment helps to determine the current cost profit attributable to shareholders. It is normally a credit but could be a debit if prices fall.


\textsuperscript{53} SSAP 16, Para 5, 6 and 7.
Reserves in the current cost balance sheet include revaluation surpluses or deficits. The term 'Current Cost Reserve' is used in the standard to replace capital maintenance reserve in ED 24 and includes where appropriate:

(i) unrealised revaluation surpluses on fixed assets, stock and investments, and
(ii) realised amounts equal to the cumulative net total of current cost adjustments, i.e. the depreciation adjustment and any adjustment on the disposal of fixed assets, the two working capital adjustments (COSA and MWCA) and the gearing adjustment.

The content of current cost accounts is a profit and loss account and a balance sheet together with notes. Corresponding amounts also have to be shown. Assets and Liabilities are included in the balance sheet at their 'value to the business'. Inflation adjusted figures can be published either as a supplement or as part of main accounts. The statement applied principally to companies listed on the Stock Exchange and to large private companies.

The capital maintenance adjustment in SSAP 16 is a modification of the basic capital maintenance concept using which the current cost operating profit is determined. SSAP 16 seeks to maintain only the shareholder's proportion of operating capability\(^{54}\). However, SSAP 16 soon ran into rough weather. It was criticised on various grounds:

(i) The first three adjustments provide scope for plenty of cosmetic calculations and the final income figure may be too subjective for legal and tax purposes\(^{55}\).
(ii) The gearing adjustment has at least three major faults\(^{56}\).
   (a) It does not directly recognise the inflation rate.
   (b) It must be small in size when the other three adjustments are small (e.g. for firms such as investment trusts that do not own substantial amount of stocks or machinery but may be highly geared).

\(^{54}\) Clayton, Peter & Blake, John, INFLATION ACCOUNTING, Op. Cit., P-24
\(^{55}\) Baxter, W.T., INFLATION ACCOUNTING, New Delhi, Heritage Publishers, 1985, P-175.
\(^{56}\) Ibid, P-176.
(c) Despite the standards claim to the contrary, it takes credit for gain (exactly comparable with appreciation of land) that will normally not be realised for many years. Apart from the above mentioned faults, the gearing adjustment can also be criticised on the following grounds:

(d) It fails to distinguish between the proprietary and entity concept of capital maintenance. Maintenance of operating capability (i.e. fixed assets, inventories and monetary working capital) implies an entity approach to capital maintenance. On the other hand, determination of current cost profit attributable to shareholders implies a proprietary or equity approach to capital maintenance.

(e) There is no generally accepted definition of 'gearing', whether preference share capital is to be included in 'equity'. Different definitions of equity may lead to different income figures.

(f) Gynther, Mathews and others have held that holding gains on long term borrowings can be distributed as dividends only if the operating capacity is run down or if additional finance is raised. SSAP 16 has admitted that a full distribution of current cost profit attributable to shareholders may make it necessary to arrange additional finance (equal to gearing adjustment) to avoid an erosion of the operating capacity of the business.

(iii) Another objection to SSAP 16 was the element of subjectivity in the calculation of MWCA. The definition of MWC adopted by SSAP 16 may have been theoretically sound but was likely to raise problems in practice.

(iv) The valuation method was not well defined. Many companies rejected it on the grounds of undue scope for subjectivity and information and on cost benefit considerations. Some argued that CCA information was not relevant to their particular industries and circumstances.

59 ASC, SSAP 16, Para 23.
At a special meeting of ICAEW in July 1982, a motion ‘that members of ICAEW deplore the introduction of SSAP 16 and call for its immediate withdrawal’, faced a narrow defeat but the results reflected the magnitude of resistance to SSAP 16.

The ASC and its work was then subjected to a thorough face lift under its new chairman, Mr. Ian Hay Davidson. Four new sub-committees were established including the Inflation Accounting sub-committee to suggest amendments to SSAP 16. The recommendation of the CCA Monitoring working party was that the main accounts should reflect the effects of changing prices, the presentation of only one set of accounts being implicit. It also recommended that there should be enough flexibility and simplicity in the presentation of inflation adjusted accounts. The ASC came to the conclusion that information about the effects of changing prices should be provided when the effects are material and the usefulness of the information justifies the cost if its preparation. It therefore, proposed that the standard be restricted to public limited companies except valued based companies (e.g. investment and insurance).

Again, the ASC issued exposure Draft No. 35 (ED 35) ‘Accounting for the Effects of Changing Prices’60 to come into effect from January 1985. It retained the basic concept of CCA and the changes related to the disclosure requirements of the standard and the companies to which they apply. It applied to all public companies except value based companies and wholly owned subsidiaries. The current cost information was to be given in a note to the main accounts rather than in supplementary current cost accounts. It would include the four current cost adjustments(as in SSAP 16) and any other material adjustment. The gross current cost of fixed assets and inventory and the accumulated current cost depreciation were to be disclosed separately. Except for gearing, all other current cost adjustments were calculated in the same manner as in SSAP 16.

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Gearing could be calculated either by the SSAP 16 method, i.e. the gearing adjustment representing the movement in the realised element of current cost reserve (sum of the three adjustments in the profit and loss account) which is financed by borrowings. A second method was to apply the gearing ratio to the realised and unrealised elements of the current cost reserve taking into current total balance sheet changes rather than the current cost adjustment in the profit and loss account. This method was first recommended by the New Zealand CCA standard. The third option was to recognise purchasing power gains on debt, based on movements in the general price index similar to the one recommended by Australia in its exposure draft on CCA\textsuperscript{61}.

In addition to the main current cost adjustments, outlined above, the determination of current cost profit required certain other items to be measured in accordance with the current cost convention; adjustments in respect of net gains or losses on disposals of fixed assets, the share of profits or losses of associated companies minority interests and extraordinary items. These adjustments were required to be shown separately. This enabled calculation of current cost earnings per share and dividend cover to be made and the impact of price changes on the profit or loss for the financial year to be assessed\textsuperscript{62}.

ED 35 also came in for severe criticism. It reduced the disclosure requirements and the significance of the current cost information by recommending its inclusion in a note rather than separate set of accounts. The Council of the Chartered Association of Certified Accountants attributed this failure to develop a widely acceptable method to the fact that attempts were always made to impose a single solution on a multitude of different business circumstances. It thus recommended withdrawal of SSAP 16 and ED 35 and development of a new standard which would take into account the diverse nature of business.

\textsuperscript{61} Gupta, Ramesh, 'Inflation Accounting: Perspective and prospects', op. cit., P. 467.

Following widespread criticism ASC withdrew ED 35. The Councils of CCAB member bodies accepted ASC's recommendation that the mandatory status of SSAP 16 be suspended until a new standard was developed. However, SSAP 16 was to be retained for authoritative reference on accounting under the current cost convention. ASC planned to make use of the standard with supplementary material as the official handbook of Accounting for changing prices. In recognition of the fundamental importance of the effect of changing prices on accounts, ASC decided to keep under active development and review, means of improving cost effective calculation and effectual disclosure of information about changing price levels to encourage companies to do the same and to ensure a wider understanding of the subject.

Earlier, during the year 1983, the Institute of Cost and Management Accountants, U.K. (ICMA) also submitted a recommendation to ASC as potential successor to SSAP 16. ICMA believed that any method of inflation accounting should take cognisance of changes in the purchasing power of money and in the prices of assets employed by the business. The effect of inflation on profits had to be shown as a two line adjustment in an 'Appropriation Account'. This would entail a deduction for capital maintenance (offset by revaluations) from profits after interest and taxation to provide for maintenance of equality value in real terms and to arrive at the amount attributable to shareholders. Balance sheets were to be augmented to show assets at historical and revalued costs. The Statement of Sources and Application of funds was to be augmented to show how much of the apparent expansion of capital employed would compensate for inflation and how much was real. An analysis of the two line Appropriation Account was to be shown in the notes to the accounts. ICMA regarded these recommendations as straightforward and flexible to give a true and fair view.

However, ICMA's recommendation was not appreciated by the users of accounting information. A survey commissioned by the Chartered Association

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of Certified Accountants was carried out in U.K. (1987) on behalf of ASC, covering 292 preparers, users and private shareholders but excluding auditors. As per the findings of the survey, most preparers and users felt that, unless inflation reached a level of 10%, there was no cause for concern regarding the accuracy of historical cost accounts. Both preparers and users felt the need for a new Statement of Recommended Practice (SORP) to be issued by the ASC. As compared to preparers who would prefer an optional and non-specific statement, users were in favour of published financial statements that would indicate the effects of inflation and preferred a mandatory and specific statement.

India
In our country corporate accounts presented to the revenue authorities and the shareholders are prepared on historical cost basis. Despite high rates of inflation, developments relating to inflation accounting in our country are not commendable.

At the professional level, development may be studied form the viewpoint of interest taken by the Institute of Cost and Works Accountants of India, (ICWAI) and the Institute of Chartered Accountants of India (ICAI), in the problem. The Research Division of ICWAI published two books on this subject in 1975. The first book “Inflation Accounting: Tools and Techniques” presents a study undertaken by P. Chattopadhyay including a couple of case studies to show the impact of inflation on financial statements64. The second publication “Inflation Accounting as a Tool to Fight Inflation” by Bahadur Muro 65 traces the developments including case studies of four enterprises besides case studies on social accounting, government operations and national accounting.

The ICAI issued a guidance note ‘Accounting for Changing Prices’ 66 in December 1982, with the object of encouraging the adoption of accounting for

65 Muro, Bahadur, INFLATION ACCOUNTING AS A TOOL TO FIGHT INFLATION, ICWAI, Calcutta, 1975.
price level changes to be presented as supplementary information in addition to annual historical cost accounts. The guidance note specifically considered three proposals:

(i) Periodic revaluation of fixed assets along with the adoption of LIFO formula for inventory valuation.


(iii) The Current Cost Accounting Method.

The main recommendations were as follows:

(i) The adoption of any inflation accounting technique would involve time, money and skill but its importance necessitates that large companies develop necessary systems to prepare and present such information.

(ii) CCA method appears to be appropriate in the context of the economic environment in our country. Until the introduction of a full fledged CCA method, the impact of inflation on trading and manufacturing concerns could be depicted through periodic revaluation of fixed assets and the LIFO method of inventory valuation.

(iii) Although selection of price indices depends upon the circumstances in each case, price indices published by the government in its monthly bulletin would be applicable to a majority of cases.

Though recommendatory in nature, the Guidance Note was a welcome step that was likely to help the management in investment and dividend decisions, pricing policy and the overall corporate performance.

The National Council of Applied Economic Research recommended\(^\text{67}\) that depreciation allowances should be made obligatory to cover the replacement cost of fixed assets. It further recommended that the central Govt. should compile an index number of prices of important types of machinery used in industry to enable the computation of replacement costs.

The Federation of Indian Chambers of Commerce and Industry organised a workshop in 1979 to study the effects of inflation, its advantages and disadvantages etc. The workshop emphasized the need to create awareness of the inflation accounting concept within the corporate sector, the government, shareholders, workers, banks and financial institutions.68

The government, however has, not taken any action to bring about amendments in the Companies Act to incorporate the effects of changing prices in the accounts. Although the Companies Act permits the change of method of depreciation and revaluation of assets, the Income Tax Act does not recognise the same. Under the Income Tax Act Rules, depreciation is charged with reference to the original cost and the prescribed rates and methods. The cost of materials is charged on the basis FIFO, and the base stock methods are rejected if they do not afford a true income 69.

The Choksi Committee too, did not favour depreciation provisions based on replacement costs70. However, in view of the increase in prices and the demands made by the industry, the government increased the general rate of depreciation from 10% to 15% 71. In 1977, the Government appointed the Sachar Committee to suggest changes in the Companies Act (1956) and the Monopolies and Restrictive Trade Practices Act (1969) in order to make them simpler and more effective. One of the recommendations made by the committee which submitted its report in 1978, stated: “In view of continuous increase in prices, companies should make a provision by setting aside 10 percent of their profits after tax as a replacement reserve, provided that such a reserve be treated at par with depreciation under the statutes of the country”72. This recommendation relating to inflation accounting, by a Government Committee was the first of its kind in our country.

71 Budget – 1983-84 of the Central Govt. of India.
The Economic Division of the Department of Economic Affairs of the Ministry of Finance also appointed a committee in 1977 under the Chairmanship of A. Bagchi, to study the need and feasibility of Inflation Accounting in India. The Report of the committee submitted in October 1978, was not made public, but it favoured the adoption of Current Cost Accounting.

Developments at the academic level are not commendable. A few books have been published. A few research projects to study accounting for price level changes in the Indian context have been undertaken. Researches have been conducted by L.S. Porwal, N. Misra, R.C. Gupta, S.K. Basu, G.C. Maheshwari, L.C. Bhandari, S.K. Gupta, S.B. Meera etc. of late inflation accounting has been included in the curricula of various academic and professional courses.

At the corporate level, a few enterprises have been publishing unaudited supplementary price level adjusted financial statements. It may be regarded as the starting point towards a permanent solution to the problem.

The various reasons cited for non-adoption of inflation accounting methods include: lack a government support, practical difficulties in implementation, a general unawareness towards the problem, suitable allowances made by the management for the impact of inflation based on guesswork and experience and the belief that it would discriminate against the company reporting it first in that industry sector.

The problem of inflation accounting is so widespread, that international organizations have also made contributions towards the development of an appropriate solution.

The wide range of approaches to the problem of inflation accounting in various member countries of the International Accounting Standards Committee have made it difficult to draft a detailed proposal for an International Accounting Standard. In 1976, International Accounting Standard No. 6 (IAS 6), 'Accounting Treatment of Changing Prices', was issued\textsuperscript{75}. It simply required that the published accounts should include a description of the methods used to account for inflation.

In November 1981, International Accounting Standard No. 15 (IAS 15) entitled 'Information Reflecting the Effect of Changing Prices' was issued\textsuperscript{76}. IAS 15 required that enterprises whose levels of revenues, profits, assets or employment are significant in the economic environment in which they are presented should, use an accounting method reflecting changing prices to disclose:

(i) the adjustment to or adjusted charge for depreciation,
(ii) the adjustment to or adjusted charge for cost or sales,
(iii) adjustments relating to monetary items,
(iv) the overall effect on results of the adjustments described in (i), (ii), and (iii) as well as any other items reflecting the effects of changing prices that are reported under the accounting method adopted,
(v) the current cost of property, plant and equipment and of inventories, when a current cost method is adopted.

IAS 15 also required disclosure of the method of inflation accounting adopted to compute the above mentioned adjustments and the nature of indices used. Information relating to inflation accounting was to be provided on a supplementary basis unless such information was provided in primary financial statements. The explanation attached to IAS 15 discusses both CPPA and CCA approaches. It also discusses the variations between

\textsuperscript{76} International Accounting Standards Committee, 'Information Reflecting the Effects of Changing Prices' (IAS 15), London, IASC, November 1981.
different types of CCA approaches. IAS 15 is designed to promote wider disclosure without imposing a specific approach.

An Exposure Draft of a proposed International Accounting Standard on "Financial Reporting in Hyperinflationary Economies" was issued by IASC recently. It recommended that financial statements of enterprises reporting in the currency of a hyperinflationary economy, whether based on historical cost or current cost approach, should be restated in terms of the measuring unit, current at the balance sheet date. The gain or loss on net monetary position was to be included in net income. The standard outlines the characteristics which provide indication of a hyperinflationary economy. Balance sheet items were to be restated, by applying a general price index to items not already expressed in terms of the measuring unit current at the balance sheet date. Similarly, items in the income statement also need to be restated in the measuring unit current at the balance sheet date. Before such restatement, cost of sales and depreciation are recorded at current costs at the time of consumption whereas sales and other expenses are recorded at their money amounts. The corresponding figures of previous years are also to be stated in terms of the measuring unit current at the balance sheet date.

U.N. WORKING GROUP REPORT ON "INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING BY TRANSNATIONAL CORPORATIONS.

A major objective of the U.N. Working Group of Experts was to harmonise the disclosure practices transnational corporations. The Report (1977) recommended the disclosure of accounting policies including overall valuation methods such as historical costs, replacement value, general price level adjustment and other bases of valuation.

EUROPEAN ECONOMIC COMMUNITY (EEC) DIRECTIVES

The main aim of EEC Directives on company Law is to create a unified business area in which the companies of member countries, competing for the same resources and markets are also subject to the same accounting, legal,
tax and disclosure requirements. The EEC directives and regulations thus help in the process of harmonising disclosure practices.

The reporting guidelines of the Fourth EEC Directive on company law, approved by the EEC Council in July 1978, require disclosure of tax based items such as additional depreciation, all reserves through the income statement, cost of goods sold and Assets and Liabilities by category. The Directive retains historical cost for asset valuation, but the use of replacement value or any other method based on current or market values is permitted. The difference between the historical cost values and replacement cost or current values must be aggregated and should be disclosed separately as an item of revaluation reserve in owner's equity. This revaluation reserve may also be disaggregated accordingly to main asset categories to which they pertain. Thus, the Directive retains historical cost as the basis of measurement, but leaves the option of requiring price level adjusted information, to the member countries. Moreover it does not suggest any particular method.

Thus various proposals have been put forward over the years, to show inflation adjusted figures in annual accounts. Earlier CPPA was favoured by most countries including U.K. and U.S.A.. However, it was argued that the general price index may not be relevant to price movements of an individual company's assets and hence the inflation adjusted figures would fail to show the effects of price changes on the particular company. This led to the development of CCA. Although CCA was also criticized on various grounds, it helped to overcome an important drawback of CPPA, by providing an acceptable and practical method of accounting for non-monetary assets at their current values.

All proposals relating to CCA, presented by various bodies or institutions are more or less similar with respect to the treatment of inventories (cost of sales) and fixed assets (depreciation). There are however differences of opinion regarding the treatment of monetary assets and liabilities (including
the gearing adjustment) and whether they present an 'entity' view or a 'proprietary' view of CCA profit and loss account:

- SSAP 16 presents an entity view of CCA profit and loss account. The COSA and MWCA together allow for the impact of price changes on the total amount of working capital used by a company in its day-to-day operations. The gearing adjustment reflects the movements in the realised element of current cost reserve which is financed by borrowings. Borrowings for gearing adjustment do not include funds borrowed for working capital requirements.
- The New Zealand approach is similar to SSAP 16 except that the gearing ratio reflects total movement in the current cost reserve i.e. it applies to both realised and unrealised elements of current cost reserve.
- The Australian approach also prefers an entity view of profit and proposes a method similar to MWCA. It does not recognise the gearing adjustment or the purchasing power gain or loss on loan capital. A portion of the gain or loss on holding all monetary assets and liabilities which arises from holding net monetary liabilities other than those included in MWC is transferred to a reserve.
- FAS 33 recognises the proprietary view of profit and requires the disclosure of gain or loss in purchasing power on holding net monetary items without it being adjusted against income from continuing operations. It does not distinguish between MWC and other borrowings.
- The Canadian approach does not recognise the MWCA and it replaces gearing adjustment with a financing adjustment and purchasing power gain/loss on monetary items.

Thus the subject of CCA is still open to debate. CPP Accounting has been more or less rejected and if CCA fails to satisfy users needs, alternative approaches may be developed to account for changing prices.

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77 Gupta, Ramesh, 'Inflation Accounting: Perspective and prospects', P-467-470.