CHAPTER 1

THE HISTORICAL BACKGROUND OF INFLATION ACCOUNTING IN IRAN AND THE WORLD, ALSO THE INFLATION ACCOUNTING IN THE PRESENT CONDITION
CHAPTER 1

THE HISTORICAL BACKGROUND OF INFLATION ACCOUNTING IN IRAN AND THE WORLD, ALSO THE INFLATION ACCOUNTING IN THE PRESENT CONDITION

1.0 INTRODUCTION

1.0.1 Inflation

Inflation, one of the most important aspects in studying an economy, is so common that some have called this century "the century of inflation". The term "inflation" is usually associated with increase in the prices, for the public, this increase is what they call inflation. Although, it is a general truth that usually inflation parallels to increase in prices, a certain definition that could convey its meaning comprehensively, seems to be some what different, since every increase in prices cannot be considered as inflation, e.g. a gentle rise in short term. Those who called this century, a century of inflation, considered a constant increase over an international scale. They define inflation as a constant and perceptible increase in the general level of prices over a period of time. Anyway, a gentle increase in the prices is generally known as the creeping inflation and a cumulative increase as the cumulative inflation.

Inflation is a wide spread phenomenon. Although there are various views on this subject, because of lacking coordination between reasons and the solutions, a general view cannot be drawn as the conclusion and consequently the origin of inflation cannot be the same in all cases to be overcome in the same way. Further
more, in different countries, inflation has different structures and sub-structures that cannot be analysed with the same method.

Inflation is a persistent increase in the price level. Inflation is primarily (1) demand-pull inflation or (2) cost-push inflation.

Demand-pull inflation arises when the demand for goods and services exceeds the available supply in the short run. This type of inflation frequently occurs in a ‘Full Employment’ economy which leads to competitive bidding for economic resources. Cost-push inflation usually begins with increased costs of factors of productions (wages, material cost) or increased prices of consumer goods (wage-price spiral) leading to demand for higher wages.

There are two type of price changes:

1. Specific price levels: price changes of a specific commodity or item, such as a car or house; or in a particular sector.

2. General or comprehensive price level: price changes in all goods and services.

In a technical sense, inflation refers to changes in the general price level. When the general price level increases, the dollar or rial loses purchasing power—i.e. the ability to purchase goods or services. The opposite situation is referred to as deflation. Holding monetary assets and liabilities during periods of inflation or deflation results in purchasing power gains or losses. Monetary items are assets and liabilities that are fixed in terms of current dollars or rials and cannot fluctuate.
to compensate for the change in the general price level. Monetary assets include cash, receivables, and liabilities.

Changes in the general price level can affect, adversely or otherwise, almost every business decision. Changes in the general price level can affect organizational planning, controlling, and evaluating functions:

1. Is any of the budgeted or reported net income due to inflation?
2. Did the company lose or gain purchasing power from inflation due to holding monetary assets and liabilities?
3. How did inflation affect the financial statements during the period?
4. Were changes in the general price level taken into consideration (1) When budget was prepared? (2) When dividend policy was determined? (3) When analyzing financial statements? (4) When evaluating performance of investment centers? or (5) When selecting a source or method of financing?

The origin of the inflation in advanced countries and in under-developed countries are different and require different solutions. Those countries that have no international trade, with export and import as the main part of economic exchanges, have another sort of inflation that’s different from that of those countries having less dependence upon international trade.

1.0.2 Accounting

Accounting is called the language of business, since it is based on financial reports, required information about each economic unit in given to related individual and administration. These individuals include managers, owners of
capital, creditors and financial and economic organizations. Accounting refers to preparing these financial reports about different organizations.

Accountants are those financial experts that can prepare various types of information, understand them and analyse them to increase the effectiveness of the company. Now a days no economic unit can have a clear programme for the future without this accurate financial analysis.

Financial affairs are the main source for the accountants. In a commercial unit activities like purchasing and selling of goods, machinery, paying current expenses etc are the common financial affairs. In a social unit like a sports club, financial affairs are paying current expenses, membership payment, fee and purchasing sports equipments. In a manufacturing company, financial affairs include purchasing raw materials, paying the wages and the expenses of production and receiving capital by selling shares.

Only understanding the financial affairs is not enough, they should also be able to prepare the financial reports so that it could be understandable for the other people. It should be based on the reality, too.

1.0.3 Accounting and Inflation Effects

Inflation has had a wide spread effect on the all dimensions of people’s lifestyle. Social scientist, especially economists, are seriously studying the general effects of inflation in all its dimensions to find out its negative effects.

All matters related to economy or financial affairs are under the influence of inflation. Accounting is a measure that reflects the financial consequence
resulting from making financial decisions, in the number and digits. These numbers and digits are very important for evaluating activities.

As a general definition, accounting is the real and accurate reporting of the financial affairs of a company under the management of the owners or economic agencies. The term “real and accurate” means a report that includes reliable and understandable information about the financial affairs and events of the company.

The fundamental problem concerning accounting is presentation of useful information related to the described system of accounting. This is the main role that accounting in its new concept and scope has to play.

If being “Real and accurate” reporting means to convey just and complete reports related to the financial affairs, this aspect of preparing information based on reports should be considered by the accountants.

This explanation, brings out the fact that accounting reflects the all round effect of inflation and prepares information for decision-making. It is revealing what is within, in the accounting system and with financial affairs and events without reducing or altering them and therefore accounts should present prepare information to reflect the effects of inflation.

1.1 ACCOUNTING IN THE WORLD

1.1.1 Historical Evolution of Accounting

Accounting is as old as civilization and its signs can be found in various civilizations. Accounting, like any other human science, developed in reply to increasing needs of the society. In fast process of development there has been
great change in business that can be considered as the base of accounting evolution. Here are some aspects of this history.

1.1.2 Appearance and Evolution

Although book keeping affairs, specially mutual recording is nearly 6000 years old and has been taught to the public, accounting theories are no more than a hundred years old. They started with the written document of the American universities associations such as C. E Spage, H. R. Hatfidd, W. A. Paton and British associations like F. W. Pixley, L. R. Dickess. In the last decade of 19th century and the beginning of the 20th century, most of accounting researchers were trying to describe the applied approaches. That time those attempts tended to find out the reason of using accounts but today most of the accounting researches want to find the cause and effect of relationship between the financial phenomena, for example, if the accounting approach changes, will there be a change in the price of the negotiable papers? In 1933-1934 with the approval of stock exchange law in America and founding of SEC (Securities and Exchange Commission), accounting theory had been taken under much more consideration, but that was not comprehensive, that is each individual or group had its own special approach.

At that time there was the problem of assessment of properties. Some supported substitutional values and some others, current values and the third group urged on the finished value. Accounting theory supposed that the nature of accounting decided its role, and its approach, and its effects on value of stocks. The individual approaches were used, according to the purposes i.e., first they
determined the purpose and then based on that purpose they undermined the approach. In fact the accounting theorists, acted rather “normative” and tended to apply special procedures and just few considered actual matters in accounting.

In the fiftees Jeel Dean and Miller and Modigliani were using economic analysis which brought about a bout great change in accounting. Chambers and Bell and Edwards and Ijiri also focused on providing a general theory based on financial reports. Later other matters such as financial events, value and general theory were discussed.

Chambers believes that various ways of solving accounting problem would bring contradictory effects, since new rules were not substituted for old ones. Kawaguchi accepts this view and adds that as long as compromise is the key to success, there world be a general strategy. Although it seems to be difficult, investigators try to compile those theories that could describe the real world. These theories should include the relationship among different aspects of individuals, companies and accounting techniques.

1.1.3 New Accounting in Iran

New Accounting in Iran was founded about 70 years ago. Formerly some companies like British Oil, Shahi Bank, National Bank, used accounting as an informative system. When students who went abroad came back, the scientific scope of accounting extended, but for lack of logical relationship between that technique and Iranian culture, the attempt failed. Now a days, due to a great advance in accounting and its system, American and British systems are common
and dominant over the world. Even in Iran, during these last years of 20th century, the authorities in Iran tried to convert western countries’ accounting standards to apply them in Iran. Unfortunately, traditional and native accounting based on the cultural and economic conditions were not taken into account seriously.

1.2 HISTORICAL ROUTE OF ACCOUNTING

In the a long time, the specification of Accounting constantly changes and effective factors on it regarded by university students, investigators and accounting authorities also change.

Din Kernigin has divided accounting development period in to seven ages:

1. The Age of Uniformity

Inflation phenomenon profoundly affects accounting opinions. Financial difficulties arising from factors: “cost price-tax-dividend” put companies into new cases and problems.

Another specification in this age-was the tendency to nationalize accounting in the manner that each country proposed specific technical approaches.

2. The Age of Innocence

Initially, accounting lacked any criterion or standards. Accountants were doing what they knew- For a long time accountancy only was book-keeping and there was no balance-sheet or financial note.
3. The Age of Improvisation

This age began when accountants started considering many difficulties, such as multiplicity of accounting method and neglect of some realities in their endeavours. Their criticism lead to limitation of or abandonment of incorrect approaches.

These difficulties were considered when they were pointed out and they were solved on the basis of existing techniques.

The current mentality of this age indicated that though accounting has many defects or even if it isn’t beneficial, the user of accounting information and data must adapt himself to this situation.

4. The Age of Intervention

The age of intervention shifted accounting compilation and development and accounting standards from the accountant’s profession to legislation associations.

The profession’s reaction to this intervention was an expression of dissatisfaction.

In a general interpretation, accounting profession in small governmental units are irresponsible as regards to universal needs. The unit legislates according to their benefits.

Accounting profession as the result of pressure to create collection of standards in order to gratify everybody and secure all of the user’s needs and necessities and also be fairly, identical and appropriate and firm on the other side
does not cause any problems and difficulties for management or authorities and accountants.

5. The Age of Integration

It is supposed that the age of integration was the product of the time that enabled accountants to establish relation between accounting profession and government so that it could perform effective role as advisor or investigator in the manner that doesn’t obstruct to political and governmental role of state.

The term “Integration” is used from a view point that implies recognition of universal advantages and profits. In this age, accounting profession became influential and primary advisor for government and people but, didn’t obtain specific required legislation for its rights.

6. The Age of Innovation

The age of innovation is the time that in the future, after the integration, has reached to its peak; accountants will refuse legislated requirement; for people are not disposed toward its acceptance. On the contrary, it will depended on professional expertise, and its potential investigative ability and evaluation, and new methods of gathering new data and the explanation of difficulties.

1.3 CONCEPT OF INFLATION ACCOUNTING

1.3.1 The Purposes of Financial Reporting

In accounting text books this point is emphasized that the purpose of accounting reporting is providing information for investors and users so that it can
help them in making decisions. This strategy for years and years was the main view on the accounting. According to Henderikson since the accounting considers past events of a firm, and the investors tend to receive a sight of the future, this thought has been formed that the accountants should only present that current and historical information that allows investors to predict future situation.

By revealing the effects of price changes, it is possible for the user to get a clear view about the financial affairs and their inter-relationships. Because of this reason, “FASB” forced some institutes to present information related to the effects of price changes on their activities.

1.3.2 Definition of Accounting and Its Purposes

Development in accounting is due to study and understanding of fundamental factors involved in this aspect. The main responsibility of accountants is providing financial information to financial institutes. The principal result of this process is the financial statements included in financial information. Measurement in accounting is very important since it is like the human body.

So we should know how to measure and what is the nature of the measurements in accounting. Although there are many things related to quality in accounting, the main function of accounting is processing quality information, so it would be important to study the system of measurement and recording it. First of all it is necessary to provide a suitable definition for them.

In “Accounting terminology Bulletin”, 1941, vol.1. By “American institute of certified Public Accounting”, we see this definition: “Accounting is the work
of recording, classifying and commenting on financial condition of a firm in a monetary unit and interpretation of their results". We call it the first definition.

Recently, there has been a great change in accounting and its definitions. In 1961 in a "statement of Basic Accounting Theory", we had this definition: "The process of understanding, measuring and transmitting the financial information for judgement and making decisions for its users". We call it the second definition. In fourth statement "APB" has presented this definition: "Accounting is a serviceable activity and its purpose is presenting quantity information related to the economic units, and selecting one way among various ones to make a decision". We call it the third definition.

By comparing the above mentioned definitions, we see that in the first one, recording, classifying and summarizing are the internal aspects, whereas in the second and the third ones, making decision is the external aspect that is underlined. Another idea presented by some critics is changing the measurement unit from money into a general quantity and changing the term "monetary unit" into a general one as "quantification" or "measurement" so that it is possible to use non-monetary measurements.

Supporters of historical price method believe that the accountant's duty is presenting data, which is completely clear and based on the conservative principle in business. This method up to 1960 was the dominant one in the accounting literature. After so many years, this method is supported yet. Supporters of current
price method or fixed monetary unit believe that changes in prices make it difficult to measure the financial statements.

1.3.3 Views

Social and economic changes have had a great influence on the views related to this measure. The result was evaluating the purposes in a wider extent and providing new definitions in new conditions. As mentioned before, the method which originated from historical price was for a long time the first definition. In addition to these two definitions the third one is present, too. Based on this third view, the way of making decision is the fundamental part and the measurements are computed by reasoning.

In historical prices method the "Absolute truth", is considered, but in the third view conditional or relative truth is considered. Lately, this viewpoint has been identified that the various ways of making decisions require various data, but in historical prices method we have no such point. Based on the third view evaluating the information is accountant's duty so that he could select the best way or method for the desired benefits. According to this view, accounting moves from a traditional and still situation into an ever changing and searching situation. In this third view, the theory of benefit changes into the theory of decision-making.
1.3.4 Divulgence Effect of Inflation

Financial statements were presented by the use of unit price indicator. Subsequently, in 1965, statement number(3) was issued by the accounting principle board that had mentioned potential interests of adjustable information.

At the end of 1974, a proposed statement under the title of general purchasing power was issued by the financial accounting standards board. This statement proposed the application of fixed dollar's accounting method and of course, regarded such an information as an appendix to financial statements.

Constant trend of increasing price during seventies decades in America, made clear limitations of traditional financial statements.

After assessment of proposed statement of 1974, statement No. (33) was issued. In 1979 by accounting standards board, and at the end, in 1986, the Board put an end to its life by the issuance of statement No (82).

The fundamental problem in all of these activities, is to present correct and useful information for consumers. This is the role that has been maintained for accounting. The purpose of correct and useful information is impartial, equitable and comprehensive reporting and transferring of information and incidents. This function makes clear the important role of accounting that can be named as "presentation of information for correct decision-making". In other words, the reflection of inflation effects, which are environmental for accounting, is included in this accounting duty. To reflect this information, accountants have announced the following five methods: historical price, adjustments on the basis of general
price-level (fixed dollar), replacement price, other price, present value of future cash. The two preceding methods, generally are called current price.

Naturally, accounting is not able to present information for correct decision so, disclosure of inflation effects or price changes on its broad meaning should be enclosed with accounting data. That is, because inflation effects make an impression on economic decision, accounting system which reflects these effects too, should also be the reflector of change in prices and their effect. The subject that created difference between accounting comments and caused constant debate among theorists, is the effect of price changes on financial events or the historical amount of accounting. Accounting scientists believe that since data resulting from past operation, acts as informative foundation for future decisions so it should be adapted for present economic reality until decision-maker whether, manager, investor, bank, government can make a better decision.

The use of monetary unit for recording financial narratives is an unquestionable principle for assessment of activities. Their reflection in financial statements and the use of the monetary unit as a measurement unit of inflation should be adjusted to price changes.

If we study the confidential reports and the published work of the researchers, we find that all of them have accepted adjustable financial statements and each one after mentioning difficult cases has emphasized the necessity of greater research and finding better methods of presenting statements on inflationary situation.
1.3.5 The Example of Effect Of Inflation On Accounts

Alph company is a simple business which distributes all its profits each year. It wants to continue at its present size. The following figures show its accounts in year 1, when there is no inflation, and in years 2 and 3 when there is inflation at 8 percent. Its costs and selling price move in line with the general rate of inflation.

**Conventional Accounts**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>inflation</strong></td>
<td>0%</td>
<td>8%</td>
<td>8%</td>
</tr>
</tbody>
</table>

**Profit And Loss Account**:

<table>
<thead>
<tr>
<th></th>
<th>1,500</th>
<th>1,620</th>
<th>1,750</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Opening stock</strong></td>
<td>300</td>
<td>300</td>
<td>324</td>
</tr>
<tr>
<td><strong>Purchase</strong></td>
<td>1,270</td>
<td>1,372</td>
<td>1,482</td>
</tr>
<tr>
<td><strong>Closing stock</strong></td>
<td>300</td>
<td>324</td>
<td>350</td>
</tr>
<tr>
<td><strong>Depreciation</strong></td>
<td>100</td>
<td>100</td>
<td>101</td>
</tr>
<tr>
<td><strong>Trading profit</strong></td>
<td>130</td>
<td>172</td>
<td>193</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td>36</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td><strong>Tax-50%</strong></td>
<td>94</td>
<td>136</td>
<td>157</td>
</tr>
<tr>
<td><strong>Profit after tax, wholly distributed</strong></td>
<td>47</td>
<td>68</td>
<td>78</td>
</tr>
</tbody>
</table>
### Balance Sheet:

<table>
<thead>
<tr>
<th></th>
<th>(1995) year 1 (inflation 0%)</th>
<th>(1997) year 2 (inflation 8%)</th>
<th>(1997) year 3 (inflation 8%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets - at cost</td>
<td>2000</td>
<td>2008</td>
<td>2025</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>1000</td>
<td>1000</td>
<td>1001</td>
</tr>
<tr>
<td>Net book value</td>
<td>1000</td>
<td>1008</td>
<td>1024</td>
</tr>
<tr>
<td>Working capital:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stocks</td>
<td>300</td>
<td>324</td>
<td>350</td>
</tr>
<tr>
<td>Debtors, less creditors</td>
<td>100</td>
<td>108</td>
<td>117</td>
</tr>
<tr>
<td>Cash</td>
<td>50</td>
<td>10</td>
<td>(-)41</td>
</tr>
<tr>
<td><strong>Total Net Assets</strong></td>
<td><strong>1,450</strong></td>
<td><strong>1,450</strong></td>
<td><strong>1,450</strong></td>
</tr>
</tbody>
</table>

### Financed by:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity shares</td>
<td>1,050</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Loans</td>
<td>400</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,450</strong></td>
<td><strong>1,450</strong></td>
<td><strong>1,450</strong></td>
</tr>
</tbody>
</table>

### Trading profits as % of total assets:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>9%</td>
<td>9%</td>
<td>12%</td>
<td>13%</td>
</tr>
</tbody>
</table>

### Cash Flow:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit after Tax</td>
<td>47</td>
<td>68</td>
<td>79</td>
</tr>
<tr>
<td>Add back: Depreciation</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Less: capital expenditure</td>
<td>100</td>
<td>108</td>
<td>117</td>
</tr>
<tr>
<td>Increase in working capital</td>
<td>-</td>
<td>32</td>
<td>35</td>
</tr>
<tr>
<td>Dividend</td>
<td>47</td>
<td>68</td>
<td>79</td>
</tr>
<tr>
<td>Movement in cash</td>
<td>-</td>
<td>-(40)</td>
<td>(-51)</td>
</tr>
</tbody>
</table>

Some curious thing have happened.

In year 2, cash has fallen by 40. If extra cash retained to bring it up to 54 (equivalent to the 50 in year one plus 8 percent inflation). The dividend must be
down to 24 compared with 47 in year 1. The profit after tax has risen dramatically and no longer matches tax position.

In year 3, cash has fallen by a further 51; the rise in profit after tax is less dramatic but the discrepancy with the cash position has widened.

**INFLATION ADJUSTED ACCOUNTS**

The necessary inflation adjustments are:

<table>
<thead>
<tr>
<th></th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8% of 300</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>8% of 324</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8% of 100</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Asset purchased before year 2 :</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,20 of 1,800 plus 17%</td>
<td>105</td>
<td></td>
</tr>
<tr>
<td>Asset purchased in year 2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,20 of 108 plus 8%</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Asset purchased in year 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,20 of 108 plus 8%</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Asset purchased in year 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,20 of 117</td>
<td>6</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>117</td>
<td>16</td>
</tr>
<tr>
<td>Less : Actual change</td>
<td>101</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net monetary working capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8% of 150</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>8% of 118</td>
<td>44</td>
<td>51</td>
</tr>
<tr>
<td>Loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8% of 400</td>
<td>(-)32</td>
<td>(-)32</td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>19</td>
</tr>
</tbody>
</table>
The detailed depreciation working shown for year 3 illustrates the kind of age analysis of fixed assets which is required. In this case, the adjusted depreciation charge is, of course, percent higher than the charge for year 17 percent higher than the charge for year 1. Points to note in the detailed adjusted accounts, which follows, are:

Before taking into account the inflation adjustment for loan capital, the adjusted profit after tax (24, in year 2 and 28 in year 3) now correctly shows the amount which can be distributed as dividend without impairing the cash resources.

The gearing ratio has fallen from 28 percent to 26 percent in year 2 and 25 percent in year 3; effectively inflation has reduced the loan liability by 32 in each year and the equity interest has received a corresponding benefit; if the gearing were to be restored to the original 28 percent by further borrowing, this benefit could be distributed to the equity shareholders in addition to the amounts mentioned in the previous paragraphs.

To have maintained their real value, dividends should have increased by 8 percent in each year to 51 in year 2 and 56 year 3; actual adjusted profits after tax are 56 and 60; gross profit has increased in line with inflation and the inflationary gain on loan capital has been more than sufficient to compensate the equity shareholders for the loss on monetary working capital and the disproportionate increase in the tax charge.
Without the gain on loan capital the gross profit would have had to increase by considerably more than 8 percent to provide the required dividends;

The tax charge takes 55 percent in year 2 and 57 percent in year 3 of the profit, compared with the nominal rate of 50 percent;

The build-up of the inflation reserves on the balance sheets proves the adjusted profit figures; in practice consideration would need to be given to whether the increased net book values of the fixed assets were realistic.

Figures have been expressed in Rss each year, to make a direct comparison between the two years; the year 2 figures should be updated to year 3 Rss by applying the inflation factor of 8 percent; for example the year 2 profit after tax of 56 becomes 60 when expressed in year 3 Rss, the same level of profit as in year 3.
<table>
<thead>
<tr>
<th></th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adjusted profit and loss Account</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>1,620</td>
<td>1,750</td>
</tr>
<tr>
<td>Opening stocks</td>
<td>324</td>
<td>350</td>
</tr>
<tr>
<td>Purchases</td>
<td>1,372</td>
<td>1,482</td>
</tr>
<tr>
<td></td>
<td>1,696</td>
<td>1,832</td>
</tr>
<tr>
<td>Closing stocks</td>
<td>324</td>
<td>350</td>
</tr>
<tr>
<td></td>
<td>1,372</td>
<td>1,482</td>
</tr>
<tr>
<td>Depreciation</td>
<td>108</td>
<td>117</td>
</tr>
<tr>
<td></td>
<td>1,480</td>
<td>1,599</td>
</tr>
<tr>
<td>Gross profit</td>
<td>140</td>
<td>151</td>
</tr>
<tr>
<td>Loss on net monetary Working capital</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Trading profit</td>
<td>128</td>
<td>142</td>
</tr>
<tr>
<td>Interest</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Less : Gain on loan capital</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>124</td>
<td>138</td>
</tr>
<tr>
<td>Tax</td>
<td>68</td>
<td>78</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>56</td>
<td>60</td>
</tr>
<tr>
<td>Dividend</td>
<td>68</td>
<td>79</td>
</tr>
<tr>
<td>Over – distribution</td>
<td>12</td>
<td>19</td>
</tr>
</tbody>
</table>
### Adjusted Balance Sheet

<table>
<thead>
<tr>
<th>Description</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets - at adjusted cost</td>
<td>2,160</td>
<td>2,333</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>1,080</td>
<td>1,167</td>
</tr>
<tr>
<td><strong>Net book value</strong></td>
<td>1,080</td>
<td>1,166</td>
</tr>
<tr>
<td>Stocks</td>
<td>324</td>
<td>350</td>
</tr>
<tr>
<td>Debtors, less creditors</td>
<td>108</td>
<td>117</td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
<td>(-) 41</td>
</tr>
<tr>
<td><strong>Total Net Assets</strong></td>
<td>1,522</td>
<td>1,592</td>
</tr>
</tbody>
</table>

**Financed by:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Shares</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Inflation Reserve</td>
<td>72</td>
<td>142</td>
</tr>
<tr>
<td><strong>Loan</strong></td>
<td>1,122</td>
<td>1,192</td>
</tr>
<tr>
<td></td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,522</td>
<td>1,592</td>
</tr>
</tbody>
</table>

**Representing 8% inflation on equity**

- Interest at end of previous year: 84, 89
- Less: profit over - distributed: 12, 19
- Balance at end of year 2: 72, 72
- Trading profit as % of total assets: 8%, 9%
1.3.6 Maintenance of Capital

Some of the scientists, by mentioning the privileges of adjustable statements have emphasized the problem of reality disclosure and comparable statements on inflation.

Since the interests of a company or an economic activity depend on the power and ability of the institution to recover applied capital that should be secured from the company's income, it is necessary to review these concepts again. Naturally, in the condition of inflation, specially in high inflation, the problem of basic capital recovery, needs a new definition and new calculation method that differs in both concept and calculation from historical price conditions.

Protection and maintenance of capital is a concept in which capitalized amount is separated from interest resulting from investment. The point that a company could conserve its fixed capital during an accounting period, means it was able to recover it. There are three different concepts to recovery of capital.

1. **Recovery of Capital to Fixed Monetary Unit**

   Its objective is to calculate capital maintenance with historical price. That is, interest exists when the company earns more income from initial investment.

2. **The recovery of capital to the unit of money purchasing power**

   In this concept, capital amount is recovered due to the decrease of money purchasing power during inflation. That is, the interest or dividend gains when the company earns an income more than the equivalent of adjusted capital amount. In
the same way, this concept can be regarded as a concept of capital recovery to purchasing power unit.

3. Recovery of capital to the merchandize units as a “initial unit”.

In this concept, the real interest of dividend which earns from the capital recovery level and which takes into consideration during inflation, only can be earned when an income more than the price of goods replacement or sold assets for current price is gained. This concept of capital recovery is also called as production capacity or commercial capacity. That is, it is replaced with the number of commodity unit or the asset coming out of company.

Apart from disagreements and agreements about theoretical and practical problems about the effects of price changes on financial statements, there are also other important problems in this case.

This point along with studies that were performed on the theoretical and practical effects of inflation on accounting concepts especially after the manifest 0 number 89, were the outcome of accounting principle collection board that lead to the issuance of principle number 107 which is self was based on “Fair value” effects. This principle has considered appropriate disclosure of existing present value for some of the financial tools by the companies and has considered necessary adjustment of the liabilities and assets related to financial statement on the basis to day’s fair value for proposed items.
1.3.7 Majority Opinion

Today, detailed methods of accounting have been adjusted somewhat to present services to the consumers, and these changes and adjustments meet in significant portion of consumer's needs. So, it can be considered that fundamental accounting principles has not changed so much. Although fundamental and basic accounting principles has remained unchangeable, at present. The same principles are interpreted and explained from the viewpoint that has more attention to the consumers. What has changed is interpretation and explanation of accounting methods and not the fundamental and basic accounting principles.

Information which is provided by the accountants to interpret and explain to consumers is divided into two groups of financial management and accounting. Accountants supply the information related to financial activities and operational investment for domestic decision-maker, because they are responsible for fulfilling profitability objective. Managers need to inform how they performed activities in the past and prepare programs for the future.

Accountants supply a group of financial reports and transfer them to external decision makers till they can assess the success of the considered unit in attainment to its objectives.

Generally, in present condition, accounting, in practice, has a tendency to present information in historical prices method. Accountants should present theoretical and practical backgrounds of attitude towards existing situation arising
from inflation by accounting scientifically and by creating advanced professional
environment. We can confess that all of the inflational accounting researchers and
critics have abstained from total rejection of adjustable financial statements and
they have only cited difficulties.

Today, accounting on the historical basis has been accepted as a manner
and each kind of deviation from it is considered as a custom-breaking. So far,
foundation of accounting on the basis of historical price cost and related practical
methods has resisted much criticism. But reality requires that accounting
professions abandon accounting historical price and make a new design.

1.4 HISTORY OF INFLATIONARY ACCOUNTING

1.4.1 Initial Studies

It is a long time that price changes have created significant problems in
evaluation and comparision of financial statements. Professor William Paton has
propounded as this: “dollar’s value-its purchasing power-has been exposed to
serious change for a certain period of time….“ Accountants work with unstable
and changeful monetary unit and so of adjustable financial statement had
displeased them more or less, because it had been misleading mostly.

The first investigatory and methodological task in connection with inflation
effects on accounting information and financial statements was performed by,
Henry Sweeny in accounting doctorate thesis in 1927 and then in 1936 was
published under the title of a “Adjusted accounting”. In this book Sweeny has tried
in a reasonable and descriptive manner to present a view along with a proposal to supply financial statement with a monetary unit. Because he believed that measurement rules have not been observed: “In other words, like other accounting researchers, I have been occupied with multiplication, divisions, subtraction and addition of numbers together that have not enjoyed a uniform quality. Such as add 1000 banana to 1500 pineapples and call the total 2500 apples.”.

How could we measure by a ruler that longed 8 inches in one day and 12 inches in another day and 22 or 24 inches in another time. I should have a suitable monetary unit for measurement before wanting to do a suitable measurement of values.

Former president of America Ronald Regan in the course of one of his televised speeches about American economic policies, showed a bank note of one dollar to people and said that this bank note that had value of one dollar in 1960, has value of now only 36 cents. That is, it has lost 2/3 of its purchasing power.

Magdaf, presenting two tables of indices related to the wholesale prices in U.S.A during one and a half century of capitalism tried to show that inflation along with capitalistic order rules effectively the economic universe.

Today, all of the world’s countries, with the intensity and weakness in different degrees, are affected by inflation.

As we mentioned before, it was propounded by Dr. Sweeny for the first time. In 1960’s decade, his book was printed and published. In December of 1947,
the board of accounting procedures and the association of American Expert accountants in Bulletin number 43, took into consideration the problem of price change and in 1963, series of studies were performed in this association. They were published in the name of reporting the financial effects of price-level changes.

After some time, the committee on accounting procedure and accounting research division studied the problem of price changes and concluded that price-level changes do not enjoy extra importance that need adjustment, in spite of the fact that they constantly observed, registered and reported the increase of prices.

1.4.2. Next Changes

In June 1969, The Accounting principle board issued statement of No (3) under the title of adjustable financial statement on the basis of general price index and recommended its usage. This board supported the issuance of improved financial statement as appendix information, so that companies can disclose this information, if they do not use them basic statements.

On 31 December 1974, report draft in the name of financial reporting in units of general purchasing power was issued by the newly-established committee in the name of accounting standard board. The main points which were discussed in this draft were:

(1) The use of unit of money purchasing power to measure the items.

(2) Intermediate comparison

(3) Benefit measurement
(4) Disclosure of inflationary effects.

The presentative method in this draft, basically is the method that in 1963 has been proposed by the Association of American expert accountants. Some of the American companies present adjustable historical financial statements in terms of general purchasing power of money.

On fifteenth February 1974 “Financial accounting standards board” announced in a statement that it is necessary to report effects of price-level changes as information along with financial statement of historical price.

On September 1979 “Accounting standards Board” in statements No (33) emphasized that if the total assets of company are one billion dollars or their net installations and equipments stock is more than 125 million dollars, it is necessary to present suitable information in addition to financial statements. In 1986, inflation rate in America reached its lowest level to 2 percent in 80’s decade. For this reason in the same year, through the issuance of statement No (89) by accounting standard board, the necessity of disclosure of inflationary effects and price changes was dismissed. But instead of making it necessary, the board encouraged to present such an information voluntarily and optional.

Among these opinions, we can point to Rosenfield opinion that supported the attempts of “Accounting standards collection board” that was a positive step in the course of improvement of financial reporting.

Another opinion was based on Ernest and Ernest that to do adjustments is a useless task for some reasons such as interference of some non-cash and credit
costs such as company's liability in calculation of net revenue, executive costs of these adjustments, and the absence of general demand for adjustable financial statements. These opinions and research by the adherents of these opinions lead to the issuance of statement No (89) on December 1986. But discussion about financial statement continued until finally in 1991, it lead to the issuance of statement No (107). But this discussion will continue.

1.5 HISTORY OF INTERNATIONAL ACCOUNTING STANDARD

1.5.1 The Necessity of Concerned Standards

As regards accounting, according to the statement No (2), financial Accounting concepts, and qualitative characteristics of Accounting information, Accounting Standards Board announced that information about the interests of a commercial unit is beneficial when we can compare it with information of other commercial units and the same commercial units in the same period of time.

Comparison of monotonous information by used methods during different periods increases the value of information. Importance and value of information specially in the form of quantified statements depends on how different users can use it with the same language and signs.

1.5.2 Antecedent

The first attempt toward uniform accounting operation started from the first international accounting congress that was held in Missonri province in 1904. The
subject of this congress was to spread the extent of accounting operation. Different opinions were presented about importance of internationalization of Accounting.

Following these steps, in 1950 many attempts were made to internationalise accounting methods. A tripartite committee was established with members from America, England and Canada and the group was delegated to conduct research about international accounting. The aim of this committee was to gather adjusted studies about theory and practice of accounting in member countries.

This committee issued more than twenty reports about accounting and auditing. The issuance of these reports indicated that we can agree on the point that collection of national standards may be difficult. The tenth international congress was held in Sidney in 1972. The resolutions of this congress were regarded as a tool to international accounting.

Some proposals were presented to establish an organization to collect the same standards for member countries. And international accounting standards committee shifted to the center of London on June 1972, to hold its first gathering. Following these activities, many advances on uniform accounting were made at national, regional and international level.

1.5.3 Organization for Collection of International Standards

During recent years, different organization at national and international levels made attempts to improve quality and benefits of comparative information of commercial units. These organizations include International Accounting Standards Committee, Cooperative and economic development organization of
European Economic community which has taken steps to methods and financial reporting and each one had matter.

\textbf{Accounting Standards Committee}

is issued 31 standards from the its establishment in 1973 3. Four research programmes in first inquiry stage were ee has collected comprehensive basis and mould of id has encountered with the subjects of reporting and retical level. Even this congress has collected standards have been without them at national level.

\textbf{Economic Development Organization}

organization are 24 developed countries that are also the economic community. The objectives of this organization bring about long-term economic growth of the member

\textit{Id}d trade development.

\textit{Economic} growth of developing countries the organization issued guidance on activities and ases by multinational companies. In this guidance, the the need for better qualified information. This guidance
International companies to have a special attention to
and provide financial information on this matter.

Collect this information, the organization, delegated a
rup in 1978 and a fundamental research group to study
member countries so that common guidelines could be
on of financial statements.

JN)

general meeting, appointed a group to study international
id economic growth. The conclusion of this study was that
ancial comparative information, was not issued by
s. This group recommended that the accounting system and
ould improve.

is group announced a few of disclosure cases of financial
rmation. Economic and social consultation sections of
organized a research group consisting of member countries
ards. A significant point was that this group has taken into
g countries also.

mic Society

an industrial countries organized a society of members
e-third share of total world trade. This society has also
ernational accounting standards. The guidance of this
of financial statements of limited liabilities companies
which has been the main guidance of this organization. Seventh guidance of this society was issued in 1976 to necessitate multinational companies to supply compound financial statements according their national rules.
REFERENCES


