CHAPTER 3

IMPORTANCE OF THE STUDY, SCOPE OF THE STUDY AND LIMITATIONS OF THE STUDY
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3.0 IMPORTANCE OF THE STUDY

3.0.1 Importance of Industry Share in Economic Development

Industry is one of the most important sectors in economic development. It is paving the way for other economic sectors including agriculture, education, health and therapy, transport, energy, communication, building and road construction, culture and information. Without the industry’s assistance, activity of other sections is difficult and nearly impossible in the modern world. The industry makes tools and machinery for itself and for other economic sections. Tools and machinery made in industry section bring and employ the material and industrial energy to the service of society. It is possible to save, analyse and transfer data to the surrounding world. Thus, without industry, production and exploitation of resources would be very low and slight in other sections.

Financial statement analysis can be a very useful tool for understanding a firm’s performance and condition. However, there are certain problems and issues encountered in such an analysis, which call for care, circumspection and judgement in such an exercise.

Many companies, particularly, the large ones, have operations spanning a wide range of industries. Given the diversity of their product lines, it is difficult to find suitable benchmarks for evaluating their financial performance and condition.
Hence, it appears that meaningful benchmarks may be available only for companies which have a well-defined industry classification. Even for such companies at least in Iran, the financial analyst may run into a difficulty. If information is available only about the industry average, or some other standard, and not about the entire dispersion of ratios for various companies in the industry, it may not be possible to draw meaningful inferences.

Financial accounting, as it is currently practised in Iran and most other countries, does not take into account price level changes. As a result, balance sheets are distorted and profits are misreported. Hence, financial statement analysis is vital.

Industrial companies have some latitude in the accounting treatment of items like depreciation, valuation of stock, research and development expenses, foreign exchange transactions, installment sales, preliminary and per-operative expenses, provision of reserves, and revaluation of assets. Due to diversity of accounting practices found in practice, comparative financial statement analysis may be vitiated.

Though in industry other yardsticks are commonly used in financial ratios, it is somewhat difficult to judge whether a certain ratio is “good” or “bad”. Current ratio, in inflationary situation, for example, may indicate strong liquidity position (something good) or excessive inventories (something bad). Likewise, a high turnover of fixed assets may mean efficient utilization of plant and machinery
or continued flogging of more or less fully depreciated, worn out, and inefficient plant and machinery.

Another problem in interpretation arises when a company has some favourable ratios and some unfavourable ratios, and this is rather common. In such a situation, it may be somewhat difficult to form an overall judgement about the financial strength or weakness of the company. Multiple discriminant analysis, may be employed to sort out the net effect of several ratios pointing in different directions.

### 3.0.2 Iran Industry and Inflation

Inflation in Iran in the period of 1980-2000 has been rather complex due to increase of growth rate of volume of money relative to national growth rate. The table below shows the inflation rate, difference in growth rate of volume of money and gross national product. Inflation rate is derived from difference in cash growth rate and national production growth rate.

![Fig. No. 1: Ref. Economic affairs assistance of program and budget org.](image-url)
Whenever above differences increase, inflation rates have increased and vice versa.

Original cause for increase of cash in Iran is that the government is receiving loans from the Central Bank. Whenever expenses of government related companies become higher than their income, they usually receive a loan from Central Bank. Receiving a loan from central bank by government, enhances the monetary stock and results in rise of inflation and affects the industrial operation and results in decrease or stopping of production, and this again adds to inflation.

3.0.3 Economical Prices

Determination of economic prices for production of different goods is based on present supply and demand and also different profits expected. Mechanism of determining economic prices is of a kind that creates different profits, and increases the profitability of persons and organizations that produce the goods with efficiency according to the needs of the society. Overproduction leads to loss for the producers. Loss also arises if the productive possibilities of society are not used effectively or applied in production of goods and services which are not needed in society.

Thus, the resources of the community are moved and arranged in the way goods and services are needed i.e. according to the preferences of the community.
3.0.4 Accounting Prices

The Accounting prices are based on final goods. According to accounting principles, it is an addition to official costs and a percent for profit. In accounting price, the amount of increase or decrease of demand as compared to supply is not considered. So it causes the enhancement of the price of goods which are higher in demand in society.

In accounting prices, amortization cost added to cost of production provides for replacement of amortized equipment.

But in an inflationary economy, the price of equipment and tools is increasing. Amortization cost that is calculated by common methods of accounting is based on official prices of the equipment and it is not enough to replace amortized equipments. In accounting prices, opportunity cost is not considered.

A factor’s opportunity cost is the highest price that is paid for it in other economic activities, for example if capital return rate in commercial activity is higher than in other economic activity and is equal to 30% of capital opportunity cost, for other activities it is 30% too. In fact not accounting opportunity cost of all factors in evaluating goods according to accounting methods will result in difficulties.

In a way when the accounting prices are determined for industrial products, the capital cost which apply in production is not considered. Interest is equal to
opportunity cost of capital and it is the income that results from capital application in other effective activities.

In evaluating according to accounting methods, it is assumed that capital cost is considered as a percent of final price of goods, but the percentage of profit that this assumption gives for fixed capital in productive activities, as compared to other activities is very low.

There was inflation in Iran due to increase controlled by the controlling demand volume of money supply leading to increase in market demand. This inflation created social and political problems. So inflation was to be low.

In these circumstances, assessment of inflation effect on Iran industry and determination of its extent and dimensions are very important.

3.1 SCOPE OF STUDY

3.1.1 Inflation

Inflation is an enhancement of prices continuously. Inflation is caused by two factors. First it results from increased demand and second it is caused by cost force. The first kind is created when amount of demand for goods is of short period.

This kind occurs often in an economy which concentrates on consumption completely.
Inflation is caused by cost forces initiated usually with the increase of production factors cost such as wages, related costs of raw material or continuous increase in consumption goods price.

There are two kinds of price change: First price level in particular cases such as alterations in the price of a particular good such as car, building and… Second price level is general such as prices of a group of goods or services.

Technically, inflation means a rise in the general price level. In general, when price level is increasing, rupee, dollar or rials lose their purchasing power.

Alterations of general level of prices, affect all the decisions related to commercial affairs.

These alterations affect the outputs related to organizational design and planning and control such as:

- Is any regulated budget and pure income which is reported resulting from inflation?
- Is a company which gains or loses its purchasing power by inflation successful in conserving financial assets or commitments? How does inflation affect financial commitments in the presence of inflation?

In regulating budget, determining of strategies related to allocation of dividend or in analysing of financial commitments or in assessing of investment or by change in the general price level.

Therefore, price changes can be described in two ways. One is to track the cost of specified “market, basket” of goods and services over time and to
develop a price index that describes the price changes for the market basket, because there is a diversity of items in the market basket, this is called a general price index.

The two most common general price indexes in Iran are the Consumer Price Index (CPI) and the Gross National Product implicit Deflator (GNP). The market basket for the CPI includes food and beverages, housing, apparels transportation, medical care, entertainment, and the other goods and services people buy for day-to-day living. The GNP market basket includes all goods and services that are the collective outputs of Iran.

The base year (Index year) is 1974, 1982, 1990 and 1997, for the CPI and GNP.

Rather than measuring broad market basket price changes, the second approach looks at the price movements of specific items called specific price. These prices can also be expressed as a specific price index.

Specific price indexes in practice are less homogeneous for example a price index for the construction cost per square foot of new office buildings built anywhere in Iran is considered to be a specific price index, despite the fact that construction costs vary among regions of the country and also among different types of structures.

3.1.2 Iran Economy and Inflation

Iran’s economy has undergone relatively severe inflation courses especially after the World War II.
In recent years, Iran has experienced inflation before and after the year 1978 (the year of Islamic revolution). It is better that Iran’s economy is assessed in two different periods which are mentioned above. First inflation period and its causes before the year of 1978 and second after the year of 1978. These are to be studied separately because the periods are different.

Original causes of inflation before the year of 1978 were dependent on foreign economy, back of balance in different sectors in the economy, unreasonable growth in assembling industries, decline of agriculture and most important of them, unlimited importing of goods after increase of oil price in 1973. While the main cause of inflation after 1978 was the decrease in supply of goods and government strategies (policies) regarding the budget, the most important reason was the supply being short of demand.

3.1.3 Inflation before the 1978

For assessment of first inflation period, that is, before 1978 note the table below that shows price index of goods or consumptive services in 20 years period.

From 1958 to 1978 Base year in this period is 1974, that is equal to 100, price level of goods and services before and after have been measured based on this basis. Between the years 1958-1972 it is obvious there have not accrued noticeable alterations in price level.
1974 = 100 Index year

<table>
<thead>
<tr>
<th>Year</th>
<th>Price Index</th>
<th>Year</th>
<th>Price Index</th>
<th>Year</th>
<th>Price Index</th>
<th>Year</th>
<th>Price Index</th>
</tr>
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<tbody>
<tr>
<td>1958</td>
<td>55</td>
<td>1963</td>
<td>61</td>
<td>1968</td>
<td>64,5</td>
<td>1973</td>
<td>86,6</td>
</tr>
<tr>
<td>1959</td>
<td>51</td>
<td>1964</td>
<td>64</td>
<td>1969</td>
<td>66,2</td>
<td>1974</td>
<td>100</td>
</tr>
<tr>
<td>1960</td>
<td>59</td>
<td>1965</td>
<td>64</td>
<td>1970</td>
<td>67,6</td>
<td>1975</td>
<td>109,9</td>
</tr>
<tr>
<td>1961</td>
<td>60</td>
<td>1966</td>
<td>64</td>
<td>1971</td>
<td>72,9</td>
<td>1976</td>
<td>128,1</td>
</tr>
<tr>
<td>1962</td>
<td>60</td>
<td>1967</td>
<td>63,2</td>
<td>1972</td>
<td>77,9</td>
<td>1977</td>
<td>160,2</td>
</tr>
</tbody>
</table>

Table 1: Consumption goods and services prices index

Ref. National accounts of Iran

Office of economic accounts of central bank of Iran

In some years, alteration in prices has been approximately zero; especially in the years of 1961-1970, price level has increased only 1% every year. Price index alteration in 1972 and thereafter have taken a different shape. Price index in 1972 is about 86 and in 1974 with a jump reached to 100 and then we encount a 10% increase in prices.

So that price index in 1972 is 86 and reach to 176 in 1978 that is it has become double in 5 years.
Studying the course of price index alterations from 1958-1978, we can certainly say that before 1972 there was no inflation. But between 1972 and 1978 obviously there is inflation.

If we turn to factors that affect Iran’s economy in this period, perhaps the most important event after OPEC co-ordination in 1973, is the increase of oil price level. After the oil price rise and the conversion of main part of dollars into rials, national income has increased and this has resulted in inflation by demand pull.

Although rise of price is matched by supply of goods by importation to some extent, still we can see that the force of demand shows its effect on prices level.

Results of strategies facilitating imports were economic balance with growth of imported goods and services. There were limitations such as capacity of ports, roads, commercial ways, rise of prices of many goods in world market, and dependence of Iran’s economy on foreign countries, intensified the force of inflation.

As a result of above factors, price index of consumers’ goods and services rose rapidly and its growth reached to 16.7% in 1974. In 1975, there was acceleration of growth in government expenditure accompanied by its inflative effects resulting from budget performance. But on the other hand, bank credit to private sector rose extraordinarily leading to severe rise in effective demand course.

Some short term measures by government such as fixing and regulating of price, supervising over maintenance of announced prices for goods and helped in
bringing down goods prices to general level of prices. It resulted in decrease of acceleration of rise of goods and services price index and wholesale index.

However, because of rapid rise of income and increase of urban population demand in building section increased and inflation accrued in acute form while the total index in these years was 916%, cumulative index had a growth higher than 18%.

From 1976 the effects of inflation become manifest. It was caused by several problems such as loss of skilled personnel and rise in costs of production.

Thus, from beginning of 1976 we encounter with inflationary forces caused by demand rather than inflation resulting from costs. In the other words, causes of inflation in these years had taken deep roots in of country's economy.

In the beginning, inflation ocurred with development of effective demand and grew rapidly and then created several problems in the following period. These straits in turn created inflation caused by rise in production costs and this course continued thereafter.

3.1.4 Inflation after the 1978

Main cause of inflation after 1978 was decline of supply and decrease of government budget. In the tables of 2,3 and 4, the course of prices alteration in different years after 1978 is shown. Based on consumption goods and services price index for three courses to total 20 years.
Table 2. Consumption goods and services prices index  
1982 = 100 Index year

<table>
<thead>
<tr>
<th>Year</th>
<th>Price index</th>
<th>Year</th>
<th>Price index</th>
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<tbody>
<tr>
<td>1982</td>
<td>100</td>
<td>1986</td>
<td>167,5</td>
</tr>
<tr>
<td>1983</td>
<td>114,8</td>
<td>1987</td>
<td>213,5</td>
</tr>
<tr>
<td>1984</td>
<td>126,7</td>
<td>1988</td>
<td>275,5</td>
</tr>
<tr>
<td>1985</td>
<td>135,4</td>
<td>1989</td>
<td>323,5</td>
</tr>
</tbody>
</table>

Ref. National accounts of Iran

Office of economic accounts of Central Bank of Iran published the following information.

Table 3. Consumption goods and services prices index  
1990 = 100 Index Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Price Index</th>
<th>Year</th>
<th>Price index</th>
<th>Year</th>
<th>Price index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>100</td>
<td>1992</td>
<td>1681,9</td>
<td>1994</td>
<td>301,4</td>
</tr>
<tr>
<td>1991</td>
<td>126,6</td>
<td>1993</td>
<td>211,7</td>
<td>1995</td>
<td>428,7</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1996</td>
<td>-</td>
<td></td>
<td>604</td>
</tr>
</tbody>
</table>

Ref. National accounts of Iran.

Office of economic accounts of Central Bank of Iran.

Table 4. Consumption goods and services prices index  
1997 = 100

<table>
<thead>
<tr>
<th>Year</th>
<th>Price index</th>
<th>Year</th>
<th>Price index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>100</td>
<td>1999</td>
<td>138.4</td>
</tr>
<tr>
<td>1998</td>
<td>118,1</td>
<td>2000</td>
<td>163.6</td>
</tr>
</tbody>
</table>

Ref. National accounts of Iran.

Office of economic accounts of central bank of Iran.
With attention to above tables, it is understood that rapid rise in prices continued after 1978. In some cases, it added to acceleration. With attention to table No. 1 and 2 in period of 1982-1990 consumption goods and services price index has increased 3.5 times (100/28.3).

Its increase in periods of 1990-1997 and 1997-2000 on an average was 6.5 times (600/100) and 3 times (300/100) respectively.

During the last 20 years, goods and services price index has become 32 times on an average (600/28.3). This matter is certainly indicative of inflationary circumstances.

Some factors such as unbalanced budget, economic boycott, war, increase of cash resulting from predominant unbalanced of budget have played main roles in acceleration of inflation. In these circumstances, role of inflation in industry has different aspects, which must be assessed.

3.2 LIMITATIONS OF THE STUDY

Model approach to problem solving is best but it has certain shortcomings. Every 'model' is necessarily an abstraction from reality, and thus any formal accounting-commerce and management science model is also an abstraction. Accounting model can never portray the world as it really is, in every detail. The more comprehensive view point permitted by the mathematical programming model in effect transforms all the assumptions that are made concerning the nature
of the business and the values of input data into specific implications concerning
the courses of action that might be taken.

There is, however, a price that must be paid in order to obtain such an
overall understanding of the situation. Because of its greater complexity, a
relevant mathematical programming model requires a greater effort to develop and
implement than the traditional procedures which it is designed to supplant.

The real activity and business situation is only approximated by the model,
and sum of the inputs is not always accurately known, so that the model does not
contain any expressions of policies. Many forecasts (which might be wrong) are
used to generate some inputs. Then it is clear that the "solutions' produced by the
model to real world problems are not going to be truly optimal. All that one can
hope for is that the solutions obtained with the aid of the model are better than
the solutions that otherwise would have been arrived at by using the same degree
of effort.

3.3 STATEMENT OF THE PROBLEMS

3.3.1 First

One of the problems has been the lack of accountancy principles and
norms. For example, if a unique method does not exist to measure and record the
income and expenses of institutions, it is impossible to determine the earnings of
these institutions.
Of course, in recent years, after the year 1990, the Audit Organization – AO has made many efforts in the field of compiling the technical criteria and to introduce uniform reporting methods that are quite promising.

3.3.2 Second

The following ten factors are the most important factors which restrain accounting development and the effect on present research:

1. Lack of accountancy national standards.
2. Lack of universal attention to accountants’ role.
3. Lack of control on accountants’ endeavours.
4. Little attention to accountancy profession.
5. Lack of endeavour of accountancy associations and professional institutions.
6. General and common dominance of governmental sector of economy.
7. No utilization of financial information with managements and the owner of industrial trade institutions.
8. Lack of competition between trade institutions.
9. Low level and capacity of accountancy profession.
10. Destabilized economy.

3.3.3 Third

The present study is restricted to only part of industrial section in Iran and in collecting primary data respondents did not give details of all the projects undertaken by them, due to time constraints.
3.3.4 Fourth

The accuracy of the conclusion is limited by the accuracy of the data supplied by the respondents. However, while analysing the data, due care has been taken by the researcher to ensure that the element of objectivity was maintained to the maximum possible extent.
REFERENCES:


