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1.1 Introduction

Accounting is an information system and its ultimate objective is to report such information to the users which may be helpful to them in their relevant decisions. The basic objective of accounting in the preparation of financial statements is a way that they give a true and fair view of the operating results and the financial position of the business to its various users, such as investors, creditors, management, government, trade unions, research concepts and conventions. The user's decision oriented approach to corporate reporting has been widely advocated in literature. All these documents emphasis that corporate financial reports should be designed in such a way so as to present the information which may be used by various users' groups in their respective decisions. [1] Further, such reports should also be relevant, reliable, objective, comparable, understandable, complete, timely and free from bias. The study Group of AICPA [2] believes that the objectives of financial statements can’t be best served by the exclusive use of a single valuation basis. The objectives that prescribe statements of earnings and financial position are based on the user’s need to predict, compare and evaluate earning power. There are several types of users of financial reports who have different interests in accounting data. Most of them need current information rather than historical figures. It has been advocated in various studies that financial statements which have been prepared on the basis of historical accounting do not provide relevant information to the users to aid their respective decisions and even fail to meet the criteria of qualitative attributes of inflation to be disclosed in financial statements. Under historical cost accounting (HCA) the amounts are recorded by business at the price at
which they are acquired and there will be no change in their values even if the market values of such assets change.

Among these users, especially in countries which have adopted economic planning, are the government and managers of enterprises. Their interests stem from their need for figures which help them to improve economic planning, budgeting and control, decision making, and the measurement of the performance and efficiency of enterprises. Unless the report disclose the real position, government agencies and managers of companies can not depend on these reports in building economic plans, setting budgets or taking corrective action. Since the stability of the monetary unit is obviously an unrealistic assumption in present circumstances (Scapens, 1981)[3], Historical cost accounting produces figures and data which are unrealistic, and therefore should not be the basis for preparing financial reports, which are used to evaluate performance. It states that only those business transactions that are capable of being expressed in terms of money can be recovered in the books of account. It also assumes that the monetary unit used for recording the transaction is stable in nature. The most significant and persistent complaint about published financial statements in recent years has been that they do not recognize the economic facts of life. In most countries, primary financial statements are prepared on the historical cost basis of accounting without regard either to changes in the general level of prices or to increase in specific prices of assets held, except to the extent that property, plant and equipment and investments may be revalued.[4]

Historical cost accounting is all right, if monetary unit is stable and there is no erosion in its value as a result of inflation. Inflation refers to state
of continuous rise in prices. It brings downwards changes in the purchasing power of money unit. Thus, financial statements prepared without taking into account the change in purchasing power of the monetary unit lose their significance. Inflation accounting is a system of recording all transaction on their current market price which is calculated by price index.” Inflation is a reality throughout the world. Yet its effects go unrecognized in financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) in most of the countries.

The different ways through which financial accounts can be adjusted for changing prices has come to be known as ‘Inflation Accounting.’

1.2 Financial statements

A financial statement or financial report is a formal record of the financial activities of a business, person, or other entity. A financial statement is often referred to as an account, although the term financial statement is also used, particularly by accountants. For a business enterprise, all the relevant financial information, presenter in a structured manner and in a form easy to understand, are called the financial statements. They typically include four basic financial statements, accompanied by a management discussion and analysis.

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions."[5] Financial statements should be understandable, relevant, reliable
and comparable. Reported assets, liabilities, equity, income and expenses are directly related to an organization's financial position.

Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently."

A written report which quantitatively describes the financial health of a company is financial statement. This includes income statement and a balance sheet, and often also includes a cash flow statement. Financial statements are used usually complied on a quarterly and annual report basis.

1.2.1 Balance Sheet

The balance sheet is based on the following fundamental accounting model:

\[
\text{Assets} = \text{Liabilities} + \text{Equity}
\]

Assets can be classed as either current assets or fixed assets. Current assets are assets that quickly and easily can be converted into cash, sometimes at a discount to the purchase price. Current assets include cash, accounts receivable, marketable securities, notes receivable, inventory, and prepaid assets such as prepaid insurance. Fixed assets include land, buildings, and equipment. Such assets are recorded at historical cost, which often is much lower than the market value.

Liabilities represent the portion of a firm's assets that are owed to creditors. Liabilities can be classed as short-term liabilities (current) and long-term (non-current) liabilities. Current liabilities include accounts payable, notes payable, interest payable, wages payable, and taxes payable. Long-term
liabilities include mortgages payable and bonds payable. The portion of a mortgage long-term bond that is due within the next 12 months is classed as a current liability, and usually is referred to as the current portion of long-term debt. The creditors of a business are the primary claimants, getting paid before the owners should the business cease to exist.

Equity is referred to as owner's equity in a sole proprietorship or a partnership, and stockholders' equity or shareholders' equity in a corporation. The equity owners of a business are residual claimants, having a right to what remains only after the creditors have been paid. For a sole proprietorship or a partnership, the equity would be listed as the owner or owners' names followed by the word "capital".

In the case of a corporation, equity would be listed as common stock, preferred stock, and retained earnings.

The balance sheet reports the resources of the entity. It is useful when evaluating the ability of the company to meet its long-term obligations. Comparative balance sheets are the most useful; for example, for the years ending December 31, 2007 and December 31, 2008.

1.2.2 Income Statement

The income statement presents the results of the entity's operations during a period of time, such as one year. The simplest equation to describe income is:

\[ \text{Net Income} = \text{Revenue} - \text{Expenses} \]
Revenue refers to inflows from the delivery or manufacture of a product or from the rendering of a service. Expenses are outflows incurred to produce revenue.

Income from operations can be separated from other forms of income. In this case, the income can be described by:

\[ \text{Net Income} = \text{Revenue} - \text{Expenses} + \text{Gains} - \text{Losses} \]

Where gains refer to items such as capital gains, and losses refer to capital losses, losses from natural disasters, etc.

1.3 Historical Accounting

Historical cost as the basis for corporate financial reporting is a universally recognized accounting convention which is preferred by most business enterprises. It is an accepted basis for the legal accounts of enterprises throughout the world. Historical cost accounting is based on the “cost or objectivity concept”. The unique property of the historical cost is that is based on the recording of events which have actually occurred, rather than upon contingent events, such as the price which an asset would obtain in the market were it sold or its cost in the market were it replaced. This gives basic historical cost data a unique claim to objectivity. The monetary unit of a country is an accepted basis for the legal accounts of the enterprises. Even the taxing authorities don’t recognize any basis of preparing accounts other than historical cost accounts. The accounts also appear to meet the qualitative attributes of financial reporting.

The historical cost data is possibly no longer sufficient to meet the potential needs of all users and therefore, additional data is essential for better
understanding of historical cost statements. The proponents of change in the accounting method argue that the historical cost accounting tend to lose much of its relevance during the period of changing prices.

It is the situation in which accountants record revenue, expenditure and asset acquisition and disposal at historical cost: that is the actual amount of money, or money’s worth, received or paid to complete the transaction.

The recording of business transactions under the assumption that monetary unit is stable is known as historical cost approach (HCA). Under HCA assets are recorded by the business at the price at which they are acquired and there will be no change in their values even if the market values of such assets change.

The big advantage of historical cost accounting is that it leads to absolute certainty and it fits in perfectly with the cash flow statement. HCA tells us exactly what has been paid and what has been received and therefore there is no doubt about balance sheet amounts. The alternatives, where accountants attempt to take inflation into account, can lead to many problems. There have been several forms of current cost accounting, purchasing power accounting and so on since the mid 1970s that have been proposed as alternatives to HCA. The reason the alternatives have not survived, and IAS 15 on inflation accounting is about to be replaced, if it hasn't been already, is that no one can agree on the best way to represent accounting values. HCA provides definite values, other methods don't.

1.3.1 Limitations of historical accounting

Historical accounting suffers from serious limitations:
a) **Insufficient provision for depreciation**

Depreciation is mechanism of generating funds to replace the fixed assets when the replacement becomes due. In historical cost accounting depreciation is charged on the basis of historical cost of fixed assets, not at the price at which the same assets are acquired, the provision made by way of depreciation charged on the original cost will not be sufficient for the replacement of assets.

b) **Leads to erosion of the operating capital**

The current revenues are not matched with the current cost of operations and the depreciation charged is also inadequate because it is based on historical costs. This is truth deals to loss of the operating capability by showing exaggerated and illusory figures of profits. The process of withdrawing resources from a company at a higher rate than warranted by economic profit causes erosion in the capital of an organization.

c) **Fails to present a fair value of financial position**

Balance sheet consists of monetary and non monetary items like cash, loan, debtors, creditors etc. are shown at their current money value. Non monetary items like inventory, building, land, etc. are shown at historical costing not at current value. During period of inflation, non monetary items are understated. Thus the balance sheet fails to present a fair value financial position.

d) **Comparisons over time are invalid**

During the period of continuing inflation, various items of balance sheet are based on different levels of costs and process, making it non comparable in any real sense. Rising figures for sales over a period of time
might be seen to indicate a growth in sales, but the truth may be different. Similar is the problem in relation to trend of profit. Inter period comparison can be more meaningful and useful in price level accounting.

e) The funds generated for replacement of fixed assets is not sufficient:

The provisions for depreciation is made to recover the cost of the assets against revenues arising from their use and to ensure that sufficient funds are retained in the business for the replacement of assets at the end of their working life. Depreciation on historical cost method does not represent the same amount of purchasing power as was originally invested in the asset in use. The inadequate provision for depreciation turns out to be a financial problem in the replacement of assets, whether by a similar asset or an entirely new asset.

f) Return on capital calculated is invalidated

Balance sheet becomes irrelevant as the assets are undervalued. This position in balance sheet is because of an overstatement of profit as depreciation, cost of sales and overheads are grossly understated and capital employed is understated as assets are shown at their historical cost and not at their current cost. Thus in a comparison of profit on capital employed, there is a double inflationary effect as the numerator is overstated and the denominator is understated.

1.4 Impact of inflation

Inflation has been defined as a disproportionate and relatively sharp and sudden increase in the quantity of money or credits or both, relative to the
amount of exchange business which always results in a decline in the general purchasing power \[^6\]. Inflation is defined by accounting principles Board Statement No.3 as a decline in the general purchasing power of money as general level of prices of goods and services rise \[^7\]. It is the rise in general price levels resulting from disproportionate increases in the money supply in relation to increase in the volume of real goods and services. Inflation produces figures in conventional accounting records that lack comparability of the local currency at different points of time. For example, “monetary” items such as cash, receivables, and any payables that represent money or claim on money or amounts payable in cash are automatically stated in current values, but there is no indication of the loss or gain in purchasing power from holding or maintaining such items during an inflationary period. “Non monetary” items, on the other hand, such as inventories, fixed assets, etc., which are usually evidenced by the physical existence of tangible property, are stated in a conglomeration of currency values as of the dates of acquisition. The figure conventionally shown as net income, therefore, can’t at all measure the gain or loss resulting from units of purchasing power received as revenues and the units of purchasing power consumed in obtaining such revenues.

The concept of current value accounting or replacement cost accounting rests in the analysis upon first being able to measure with some accuracy the effects of inflation, and second on assuming that inflation is not a cost of doing business. Unfortunately, the state of the art is such that no reliable inflation index exists, nor soon is expected to be created. Note of the indexes that have been constructed are able to measure quality. It is very easy to say that the cost of rupee has gone up very sharply, but it is much harder to
measure definitely the quality of that rupee. An index that fails to measure such a vital fact in our society is deficient for use in general application\cite{8}. Inflation causes distortion of reported profit, and the correction of this distortion is costly. Moreover, there are several methods for correcting the distorted data, resulting in different profit measures. The appropriate method to choose in each case depends on the managerial use to be made of the resulting data. Another damaging effect of inflation is the distortion of plans, budgets and sets of standards that were prepared in advance. Comparison of actual performance to the plan and standards is meaningless. Thus, control of individual activities becomes difficult. The external increase in input prices often provides an alibi for internal inefficiency. For example, increased costs are blamed on inflation even when inputs are wasted.

During the past three decades, the menace of inflation has universally disrupted the economic measurements in almost all spheres of human activity. The purchasing power of monetary unit dropped steadily. It has become a worldwide phenomenon to tackle the problem of inflation. The success of failure of the government is measured in curbing the rate of inflation in the country.

The financial reporting is sick, massively sick with the virus of inflation. Inflation wreaks havoc with business havoc that can't even be rectified, let alone understood, from financial statements. In today's world of persistent and seemingly endless-inflation, the old rules are found by many to be inadequate and misleading. For instance, under generally accepted accounting principles, which carry productive assets at cost of acquisition-true cost of replacing such equipment in an inflationary environment, are not
reflected. The result is that costs are understated, that income is overstated and that often earning are nothing more than phantom profits\(^9\).

Changes in the price level add interesting complexities to financial analysis. While the basic financial analysis techniques used in a non-inflationary environment still apply, the interpretation of events is somewhat more difficult. Given an uncertain world, "changing prices" only add one more element of uncertainly. Investors are already being confused by the current over recording of short term swing, which tends to obscure the basis long term trends of the bus in which they have invested. It is native to conclude that everyone is harmed by inflation, until calculations are made, we cannot be sure if inflation was helpful or harmful to a specific entity.

**1.5 Inflation Accounting (Price Level Accounting)**

Price level accounting, which is also known as "inflation accounting", "replacement accounting", "current value accounting" is a technique of accounting which takes care of the impact of price level changes on accounts. There is hardly any doubt that current inflationary conditions have been largely responsible for the present level of interest in accounting measurement. It is important to remember that accounting for price level deals with only one aspect of a much wider problem. Inflation involves a decline in the purchasing power of the monetary unit, but even if there were no inflation, there could still be variations in prices and values of goods and services which affect the well being of an accounting entity.

Some of the accounting measurement systems which have been proposed by the accounting bodies in the world attempt to deal only with the
problem of inflation, others are more concerned with substituting some concept of value in place of cost in the accounting records, and there are some which attempts to deal with both general and specific price and value changes simultaneously (AARF, 1975).

Price level accounting, which is one of such measures, is concerned with removing the effects that changes in the general purchasing power of money have an account prepared in accordance with historical accounting practice. It looks at the undertaking from the point of view of the purchasing power invested in it by its owners and of the maintenance of that purchasing power. In other words, there are two main issues relating to price level accounting:

1) Maintaining intact the capital invested in real terms.

2) Calculating profit so that it really does indicate a 'true and fair' view of a year's trading.

Inflation at today's level introduces many distortions in the economy as a whole and within the individual firm. Book keeping at all levels is infinitely more difficult and important. We can't be satisfied with the conventional measurements, economic or financial, because they no longer tell us what we need to know.¹⁰

Accountants are expected to ignore inflation, but inflation does not ignore the accounts, it makes a mockery of them (The economists, London, 1971)

Inflation accounting has shaken fundamental accounting concepts like maintenance and protection of capital, the concept of profit, depreciation for
purpose of replacing machinery, cash in hand, losing purchasing power over
times and affecting liquidity of the enterprise\textsuperscript{11}.

Price level accounting is concerned with removing the effects that
changes in the purchasing power of money have an accounts prepared in
accordance with historical accounting practice. It is suggested that better
information would be provided in relation to the use and control of assets, if
some form of replacement cost accounting were instituted. Because price level
accounting is concerned primarily with the effect of price level changes on the
measurement of profit of, and the purchasing power invested in an undertaking
(e.g. by the equity shareholders in the case of a company, or by the nation as a
whole in case of public enterprise), it uses a measure of the type that
consumers in general buy\textsuperscript{12}.

1.6 Advantages of Inflation Accounting

The advantages of Inflation Accounting include the following:

1. Historical accounting tends to inflate profits because less
depreciation based on historical costs of assets (which are usually lower) is
charged. Inflated profits, if distributed as dividend, will lead to erosion of
capital. Accounting adjusted to price level changes tends to correct this
malady by charging depreciation on current values of assets. In this way,
capital is kept intact which is essential in a limited liability business.

2. Inflation accounting helps to maintain the physical capital (i.e. fixed
assets) intact because sufficient funds are made available for replacement of
fixed assets when they are worn out by charging depreciation on their current
values.
3. Balance Sheet exhibits a true and fair view of the financial position of a firm because assets are shown at their current values.

4. For managerial decisions, the anticipated and actual profit must be expressed in rupees of the same purchasing power. Inflation accounting does this by matching the cost and revenue at current values.

5. Financial ratios calculated on the basis of balance sheets and profit and loss account adjusted to current values would provide more meaningful information as compared to the ratios based on the historical costs.

6. A rate of return on capital employed adjusted to the current price index is more useful in the valuation of business by its owners, creditors and management.

7. Employees, shareholders and public are not misled because inflation accounting shows current profit based on current prices, historical accounting shows exaggerated profit by relying on historical values which may be very low. Exaggerated profit may induce employees and shareholders to make a claim for higher wages and dividends.

1.7 Why inflation accounting

The impact of inflation comes in the form of rising prices of output and assets. As the financial accounts are kept on historical cost basis, so they don’t take into consideration the impact of rise in the prices of assets and output. This may sometimes result into the overstated profits, under priced assets and misleading picture of business etc. So the financial statement prepared under historical accounting are generally proved to be statements of historical facts and do not reflect the current worth of business. This deprives the users of
accounts like management, shareholders and creditors etc... To have a right picture of business to make appropriate decisions. Hence this leads towards the need for inflation accounting. Inflation accounting is a term describing a range of accounting systems designed to correct problems arising from historical cost accounting in the presence of inflation.

The usefulness of conventional financial reporting based on the assumption of a stable monetary unit has become the subject of intense debate during recent periods of high inflation, for it does not adequately accommodate the economic reality of price changes. Thus the impact of price changes on a business needs to be recognized if financial reporting is to be useful for decision making, setting budgets, determining costs of production and for economic planning generally. As price changes occur at a rapid pace so does the pressure on accountants, both theorists and practitioners, to provide a reporting basis which will reflect the impact of inflation.

Ignoring general price level changes in financial reporting creates distortions in financial statements such as: \(^{[13]}\)

- Reported profits may exceed the earnings that could be distributed to shareholders without impairing the company’s ongoing operations.
- The asset values of inventory, equipment and plant do not reflect their economic value to the business.
- Future earning is not easily projected from historical earnings.
- The impact of price changes on monetary assets and liabilities is not clear.
- Future capital needs are different to forecast and may lead to increased leverage, which increases the business’s risk.
When real economic performance is distorted, these distorted lead to social and political consequences that damage business.

The need for inflation accounting was not felt so long as prices were fairly stable. However, from the year 1970 the inflation has been persistent and has lent urgency to the need to adjust financial statements to reflect the effects of inflation on the operating results and financial position of an enterprise.

1.8 Need and objectives of the study

A survey of the empirical studies conducted in the field of accounting for price changes in India reveals that no comprehensive study has been undertaken to examine the corporate practices as regards that accounting for price changes. So this study has been undertaken with the following specific objectives:

- To examine theoretically various methods for explaining the effects of changing prices on financial statements, as various standards, statements, exposure drafts, guidance notes, etc. are issued by professional accounting bodies in India.

- To analyses the practices regarding accounting for price changes.

- To study the perceptions of practicing executives on various issues relating to price level accounting, such as:
  a) The need for price level accounting
  b) The methods of accounting for price changes
c) The mode of presentation of Inflation-Adjusted Accounts (IAA) in the annual report of a company.

d) The mandatory status of presentation of IAA and their auditing.

e) The utility and limitation of IAA

- To appraise the performance by applying suitable method of accounting price changes and to compare these with historical accounting results; and

- To make recommendations regarding applicability of accounting for price changes in India.

1.9 Importance of the study

In fact historical information is not useful during an inflationary period and management will receive figures that are inaccurate and irrelevant; the cost of production will be understated, profits will be overstated, and the distributed profit will be drawn from capital. The research will study a suitable system of inflation accounting for use in Steel Authority of India Limited (SAIL) to facilitate better planning and more effective control under inflationary conditions. The importance of this research lies in the fact that the India government has decided to keep the profitable enterprises in the public sector. Thus they need a measurement procedure to determine profits, i.e.; on the basis of current cost, not historical cost accounting.

Therefore, the study has the following objectives:

1. To study and evaluate the existing inflation accounting Methods and other regulations imposed by different interested bodies. This
will be done by tracing events in the real world and developments in the theory of inflation accounting.

2. To study and evaluate the current method and primary aims of financial reporting in India and the primary aims of these reports, and examine the need for improvement.

These matters will be viewed in the context of the major historical events that have affected the practice and development of accounting in India. Finally, recommendation will be made for improving inflation accounting in SAIL.

1.10 Background of Indian steel industry

Steel has been the key material with which the world has reached to a developed position. All the engineering machines, mechanical tools and most importantly building and construction structures like bars, rods, channels, wires, angles etc are made of steel for its feature being hard and adaptable. Earlier when the alloy of steel was not discovered, iron was used for the said purposes but iron is usually prone to rust and is not so strong. Steel is a highly wanted alloy over the world. All the countries need steel for the infrastructural development and overall growth. Steel has a variety of grades i.e. above 2000 but is mainly categorized in divisions – steel flat and steel long, depending on the shape of steel manufactured. Steel flat includes steel products in flat, plate, sheet or strip shapes. The plate shaped steel products are usually 10 to 200 mm and thin rolled strip products are of 1 to 10 mm in dimension. Steel flat is mostly used in construction, shipbuilding, pipes and boiler applications. Steel long Category includes steel products in long, bar or rod shape like reinforced
rods made of sponge iron. The steel long products are required to produce concrete, blocks, bars, tools, gears and engineering products. After independence, successive governments placed great emphasis on the development of an Indian steel industry. In Financial Year 1991, the six major plants, of which five were in the public sector, produced 10 million tons. The rest of India steel production, 4.7 million tons, came from 180 small plants, almost all of which were in the private sector. India's Steel production more than doubled during the 1980s but still did not meet the demand in the mid-1990s, the government was seeking private-sector investment in new steel plants. Production was projected to increase substantially as the result of plans to set up a 1 million ton steel plant and three pig-iron plants totaling 600,000 tons capacity in West Bengal, with Chinese technical assistance and financial investment. The commissioning of Tata Iron & Steel Company's production unit at Jamshedpur, Bihar in 1911-12 heralded the beginning of modern steel industry in India. At the time of Independence in 1947 India's steel production was only 1.25 Mt of crude steel. Following independence and the commencement of five year plans, the Government of India decided to set up four integrated steel plants at Rourkela, Durgapur, Bhilai and Bokaro. The Bokaro plant was commissioned in 1972. The most recent addition is a 3 Mt integrated steel plant with modern technology at Visakhapatnam. Steel Authority of India (SAIL) accounts for over 40% of India's crude steel production. SAIL comprises of nine plants, including five integrated and four special steel plants. Of these one was nationalized and two were acquired; several were set up in collaboration with foreign companies. SAIL also owns mines and subsidiary companies.
References:

1. AICPA, “Accounting Institute of Certified Public Accountants” 1887.


