CHAPTER 1

INTRODUCTION

Inflation and Accounting

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Inflation and Accounting

Inflation (or deflation) is a state of economy in which prices of commodities, inter alia, tend to increase (or decrease) continuously till the boom (or depression) is reached. At present, most of the countries of the world are passing through the stages of inflation since 1950. That is why 'inflation has become a global phenomenon'.

Although increased attention has been given to this subject over the past 30 years or so, it is not a new problem. "In the years that followed the First World War (1914-18) many countries were beset with changing price levels - and some were of fantastic proportions". Indian economy is also facing inflation recurringly. In fact, 'during this period ... of the current century, people in India have faced both severe inflation as well as severe deflation'. Inflation has added an entirely new dimension to our economy.

3. B. Banerjee, 'Inflation and Corporate Reporting in India', The Management Accountant, April 1982, The ICWAI, Calcutta, p. 188.
deal with the accounting aspect of inflation, i.e., the effect of inflation on accounting.

The main object of accounting is the generation of accounting information for making rational decisions by the internal management as well as by the external users like investors, creditors, etc. Accounting is based on certain concepts and conventions. A concept, as defined by Kohler, is 'any abstract idea serving a systemising function'.

The basic concepts are Business Entity concept, Cost concept, Going-Concern concept, Money Measurement concept, Dual Aspect concept, Realisation concept and Accrual concept. Ventures being generally of short duration, may not be too much affected by price level changes. Hence, we may exclude Venture Accounting for the purpose of present study. But inflation affects the going concerns seriously. The system of accounting generally followed for these type of enterprises is based, among others, on the going-concern concept. This concept assumes an enterprise to run for an indefinite period of time or, speaking negatively, the enterprise will not be liquidated in the near future. Accordingly, for continuing in operation it necessitates two things: (i) correct determination of periodical profit, and (ii) presenting information relating to state of affairs of the enterprise at the end of an accounting period in such a way that the "true and fair" view in this respect is communicated to the users of accounts.

With these two fold objects, the system of accounting developed for going-concerns has to show due allegiance to the 'Cost concept' and the 'monetary convention'. Cost concept hints at recording the transaction at an amount which may be more or less than the real worth of the transaction. It may be termed as historic cost. Convention refers to 'a statement or rule of practice which, by common consent, express or implied, is employed in the solution of a given class of problems or guides behaviour in a certain kind of situation'.

According to Monetary convention, all transactions, before being entered into accounts must be expressed in money value. It is needless to mention that the monetary unit has been in use for centuries as the basis of accounting. Following the going-concern concept, it is imperative that the value of money should remain constant 'through time'. But in practice value of money does not remain constant. "The basic assumption underlying valid accounting practice is that there is no persistent or continuous change in the value of money, although it is true that a certain amount of change of a cyclical nature both in respect of absolute and relative prices takes place." But if value of money does not remain constant, it will obscure inter-period comparisons of results or decisions based on accounting data without suitable adjustments to price level changes may be faulty and very often may create hindrance to

7. Ibid., p. 131.
profitable operations. According to some academics, the historic cost basis of financial accounting while showing due allegiance to the monetary convention, tends to show a distorted picture, in case of changing price levels, leaving the very objects unachieved.

Problems when accounts are maintained under Historic Cost Accounting

When accounts are maintained under conventional accounting many problems may arise in times of inflation. The root cause of all these problems may be traced to the fact that under conventional accounting profit is computed after recovery of the historic cost only. Of the cost-components, depreciation and inventories have major bearing on the profit. Realisation of historic cost of these two items creates problem of replacement of both the items since the recovered amount generally appears inadequate in times of inflation. Other components of cost may also create similar problem if recovery is made on a historical basis. This replacement problem may, in turn, threaten the maintenance of operating capability of the enterprise. Owing to the under-recovery of costs, profits under conventional or historic cost accounting are generally overstated in times of inflation. Profits (or losses) are also not reported correctly if measured in purchasing power units. Because the present system of accounting does not recognise the purchasing power gain or loss which may arise out of mere holding of monetary liabilities or monetary assets respectively for some period during inflation. These assets or liabilities, the amounts of which are fixed by contract or statute in terms of
money value, are known as monetary assets or monetary liabilities. So, it appears that inflation creates another problem of incorrect performance evaluation under historic cost accounting. Assets are also not fairly valued in the balance sheet. For example, fixed assets are generally valued at historic cost or at historic cost less depreciation and inventories are valued at historic cost (being generally lower than the market price in times of inflation). Both the valuation may lead to undervaluation. Thus during inflation both the profit and loss account and the balance sheet may not be expected to satisfy the qualitative requirements of Sec. 311 of the (Indian) Companies Act, 1956, to represent the "true and fair" view of the profit and loss position, and the financial position respectively of the enterprise, in spite of the fact that the accounts are prepared strictly in accordance with the statutory provisions. Any economic or managerial decision based on the misstated figures of the basic financial statements may give faulty results. The incorrect performance evaluation, e.g. overstatement of profit in times of inflation, may lead to payment of dividend, taxation or profit-based remuneration much in excess of what ought to have been justified. Consequently, these payments may include a part of capital. Accordingly, in spite of legal sanction to the contrary, a part of the dividend is actually paid out of capital if necessary accounting safeguards are not applied against it. This is what is termed as 'Capital erosion'.

While all the above problems are discussed in general in Chapter 2, Chapter 3 deals specifically with the various aspects of capital erosion. For analysing the capital erosion
we consider the fund approach to capital which measures capital from the liabilities side and includes both owned capital and all types of loan capital. On the contrary, the asset approach which measures capital from the asset side and includes all kinds of assets, may be considered to measure the maintenance of operating capability of an enterprise during inflation. Quantitatively, both the approaches are, however, not different. It may be pointed out that the inadequate replacement fund under historic cost accounting can maintain the nominal capital only and fails to maintain the same scale of operation. The maintenance of nominal capital may not affect the ventures. Because due to their short duration they are least affected by inflation. Hence we exclude the venture accounting from the scope of our study.

But in case of on-going concerns what is relevant in this context is the maintenance of real capital i.e. the maintenance of the purchasing power of the capital invested. To that effect repayment of loan capital, whether short-term or long-term, does not affect the maintenance of the purchasing power involved. Because repayment is made in terms of 'nominal value' only. Contrarily, it may lead to purchasing power gain. Such repayment of loan obviously reduces capital but at the same time creates capability of getting new loan. Thus, total capital remaining the same, it does not affect the operating capability of the enterprise. Regarding ownership capital it may be stated that payment of dividend on both equity and preference capital out of reported profit may lead to erosion of capital invested by the owners so much so that it (dividend payment) may exceed the net purchasing
power gain arising out of the transactions during the accounting period. However, it may be noted that deferred payment of dividend on cumulative preference capital creates a purchasing power gain to the enterprise.

Erosion of purchasing power is alternatively known as erosion of real capital. The earning power of an enterprise is affected by it. The reduction in the value of real assets caused by the same factors which cause capital erosion may cause deterioration of the solvency and the liquidity position of an enterprise. Moreover, receipt of dividend out of capital means withdrawing them unperceived by them. Gradually, a time may come, the rate of inflation rising higher and higher, when they are actually paid back their entire capital unnoticed. Even then, they enjoy the rights of shareholders although what they subscribed as share capital has entirely been withdrawn in reality. From that moment they enjoy all the rights of shareholders even without any investment in real terms.

The Measures of Inflation Accounting

In view of the above problems, there arises the need for taking suitable remedial measures. The various approaches to inflation accounting may be divided into two groups viz - (i) partial adjustments, and (ii) overall inflation accounting methods. There are two practices which suggest partial adjustments. One such practice is providing additional depreciation on the basis of replacement cost of fixed assets (with or without writing up the value of these assets in the balance sheet). The other practice is the valuation of
inventories at LIFO method. The former may help to reduce the replacement problem while the latter provides a more realistic calculation of profit by taking into account the most recent prices for items consumed during the period and by way of valuation of closing stock at earlier purchase prices, which are generally lower than the current purchase prices during inflation. It may be mentioned that both the practices may be introduced simultaneously as supplementary to each other.

The major overall inflation accounting methods include Stabilized Accounting, the Current Purchasing Power (CPP) Method, Value Accounting, Cash Flow Accounting and Current Cost Accounting (CCA). Of the above, Stabilized Accounting was the first systematic approach of inflation accounting. It was introduced by H.W. Sweeney in 1936. The method suggests restatement of the balance sheet and the profit and loss account in terms of year-end purchasing power. Monetary items having been already stabilized at current price levels need no restatement.

The concept of CPP method is similar to that of the Stabilized Accounting. This method attempts to represent the affairs of an enterprise in terms of a stable unit of measurement - General purchasing power unit as on the balance sheet date. The method contains in itself a continuous process of updating the measuring unit and thus eliminates the effects of changing money values. It aims at maintaining the purchasing power invested by the owner.
Value accounting emphasizes that 'values' rather than 'costs' of assets can provide more realistic information. But there are three variants of the method depending on the various meaning of 'values'. They are Replacement Cost Accounting (RCA), Present or Current Value Accounting (CVA) and Continuously Contemporary Accounting (COCOA). RCA provides for recovery of the replacement cost of the assets identical to the assets consumed, and for valuation of assets on a similar basis. CVA adopts 'current value' as the basis of valuation of assets in the balance sheet and the difference between the selling price and the current cost of replacement at the date of sale is treated as profit. However, 'current value' may mean 'economic value', 'current cost', 'replacement cost', 'opportunity cost' and 'deprival value'. 'Economic value' represents present value of the expected future earnings from an asset. 'Current cost' may be used for assets of recent origin while 'replacement cost' may be used for older assets. 'Opportunity cost' represents value in the best alternative use and 'deprival value' means loss due to deprival of the asset. The last variant, i.e., COCOA, which is in effect a combination of CPP and CVA, adopts current selling prices as the valuation criteria. It also considers the general price level index.

Cash Flow Accounting recognizes a transaction only if cash is involved in it. However, it considers cash flow on an accrual basis. That is, future cash flows are also considered. It may be noted that the method overcomes the problem of charging depreciation as it involves no cash flow. Instead, full amount of cash outflow for acquisition of fixed assets
CCA suggests 'value to the business' as the valuation criterion. But there are three alternative bases of the criterion. They are - Replacement Cost (RC), Net Realizable Value (NRV) and Present Value (PV). It is suggested that RC should be the basis of valuation in cases where it is not the highest of the three bases. In case RC is the highest, the higher of other two should form the basis of valuation. Operating profit is to be determined after charging 'value to the business' of the assets consumed. Thus, the operating profit automatically excludes the 'holding gains' and 'extraordinary gains' which should be shown separately. CCA suggests consideration of the specific price indices for estimating the current prices of the items. The method emphasizes on the maintenance of the physical operating capability of the enterprise. We have used CCA in the penultimate chapter for analysis of the results of the selected units. The measures for inflation accounting are, however, discussed in detail in chapter 4.

Developments in Some Countries

After a discussion on the principal measures of inflation accounting we have made an attempt to summarise the chronological developments in some developed countries like U.K., U.S.A., Australia, New Zealand, Canada, etc. The response from the International Accounting Standards Committee in this respect is also reviewed. The developments
in India are, however, discussed in a separate chapter (chapter 5). A comparative study on the latest developments of the above countries reveals that some version of CCA is favoured by a majority of the various pronouncements. The basic differences between the various CCA models lie in the treatment of the gains or losses on monetary working capital and the loan capital. The other main areas of departure of one model from the other are the form of presentation of the current cost information and the capital maintenance concept adopted.

India is also under the grip of perpetuating inflation and the urgent need of a suitable inflation accounting method is recognised simultaneously with other countries. But she appears to have just started thinking over the problem. However, Indian developments are considered from three angles, i.e., developments at academic level, professional level and Government level. Academic developments include developments by both the individual academics and the academic institutions. These developments are generally highlighted in the form of publication of books and journals, research studies, organising seminars or conferences, etc. Publication of books on the subject is not plenty in India. To have an idea about the developments through publication of articles in journals a survey of five leading journals in India over a period from 1972 to 1986 has been made. The results are shown in chapter 6.

One of the notable developments is that The Institute of Chartered Accountants of India (ICAI) issued a
Guidance Note on "Accounting for Changing Prices". It considered current cost accounting as the most appropriate method and favoured the SSAP 16 model of U.K. But in the opinion of the Institute, the introduction of a full-fledged system of CCA on a wide scale in India will inevitably take some time. During this transitional phase, the Institute recommended periodic revaluation of fixed assets along with the adoption of LIFO formula for inventory valuation.

The lone action at Government level is the recommendation of the Government appointed Sachar Committee to make a provision by setting aside ten per cent of the profits after tax as a replacement reserve provided that such a reserve should be treated at par with depreciation under the statutes of the country.

At the end of the chapter, corporate practices in India, as reflected from various studies made so far, are also highlighted.

Foreign Participation

Chapter 6 deals with the problems that may arise owing to foreign participation. We take the term 'foreigner' as non-residents; so it embraces within itself the non-resident Indians (NRI) too. Lack of proper industrial development caused mainly by too much dependence on agriculture, weak technological base and inadequate infrastructure of production and trade, may be the root cause which prompted India to depend on foreign participation. Two major forms of foreign participation are technical collaboration and
financial participation. However, these two forms of participation may be independent of the other or may prevail simultaneously in the package form. A strong research and development base is necessary both for adaptation of imported technologies and for developing indigenous know-how. But India is very weak in this respect. We discuss the problems arising out of foreign participation in the context of an inflationary situation. Foreign technical collaboration has little relevance to this effect. The financial implication of foreign technical collaboration in the form of payment of royalties, and technical fees to the foreigners has no bearing on the erosion of capital of the Indian enterprises. Similar is the case of financial participation by the foreigners in loan capital. So we keep them outside the scope of our study. The foreigners generally prefer participation in equity capital for having effective control on the Indian enterprises. The Government of India also encouraged such investments by liberalizing the regulations governing such investments. For example, a new scheme of portfolio investment for NRIs was announced in the budget for 1983-84. The tax rates applicable to such investments were also rationalised. The intention of the Government was to promote inflows of foreign capital. But such investment by foreigners was not left unabated. In fact, certain restrictions were imposed by the introduction of Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 and the Foreign Exchange Regulation Act, 1973. With a view to preventing the apprehended misuse of the liberalised portfolio investment scheme in the form of take-over bids, the Government had to resort to imposition of certain restrictions again in the form of an overall ceiling
on the total RBI holding of the paid-up equity capital, permission from the Reserve Bank of India, etc. The problem of capital erosion gets a new dimension if a portion of capital is subscribed by foreigners. The same situation, as stated earlier, may arise in case of foreign shareholders also when they have to be allowed to continue to enjoy all the rights and liabilities of shareholders without any investment in real terms. On the other hand, continuous payment of dividend on the basis of inflated profit in times of inflation even after paying out the entire real capital by way of dividend may create a continuous outflow of foreign capital. The ultimate objective of attracting foreign capital may thus be frustrated. The aim of the present study is, therefore, stated below.

**Purpose and Scope of the Study**

The purpose of this study is to test empirically the effects of inflation on foreign equity participation in India. Specifically, the following questions are sought to be answered:

1. Whether or not the payment of dividend regularly based on historic cost accounting results in erosion of capital in times of inflation.

2. Do the foreign equity shareholders continue to enjoy all the rights of shareholders without having any investment in real terms in the equity capital in the event of gradual erosion of capital arising out of payment of dividend based on historic cost accounting?
3. Whether or not there may be continuous outflow of foreign capital from the country, thus defeating the very purpose of having an inflow of foreign capital by way of foreign equity participation.

For the purpose of our study 11 companies, all having foreign equity shares, are selected and the study relates to a nine-year period, 1977 to 1985. Published data are collected from Bombay Stock Exchange Directory. The findings of the study are given in chapter 7. This is followed by concluding observations in chapter 8.

The Plan of the Study

We have already pointed out, in a summarised version, our study-plan. To reiterate, it comprises eight chapters as follows:

Chapter 1: Introduction.
Chapter 2: Some Basic Problems of Inflation under Conventional Accounting.
Chapter 3: Problem of Erosion of Capital.
Chapter 4: Inflation Accounting Measures and Developments in Some Countries.
Chapter 5: Developments in India.
Chapter 6: Problems arising out of Foreign Participation.
Chapter 7: Foreign Participation in India and its Effect.
Chapter 8: Conclusion.