## SOME BASIC PROBLEMS OF INFLATION UNDER CONVENTIONAL ACCOUNTING

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Nature of the Problems</td>
<td>18</td>
</tr>
<tr>
<td>Internal Financing and Replacement of (Fixed) Assets</td>
<td>18</td>
</tr>
<tr>
<td>Incorrect Performance Evaluation</td>
<td>23</td>
</tr>
<tr>
<td>Insidious Effect of Incorrect Performance Evaluation and capital Erosion</td>
<td>26</td>
</tr>
<tr>
<td>Misinterpretation of Financial Statements and Decision Making</td>
<td>28</td>
</tr>
</tbody>
</table>
The Nature of the Problems

Under the conventional accounting system an enterprise has to face the following inherent problems in times of rising prices:

1. Internal Financing and Replacement of (Fixed) Assets

It is not too long since depreciation has been considered as a charge against revenues. It has been so recognised after a considerable debate on the matter amongst the academics and the professionals. The various arguments advanced for such treatment of depreciation are:

(a) Depreciable asset values are 'but cost accumulations in suspense, as it were, awaiting their destiny'. That is, the costs of acquisition of these assets are nothing but deferred costs which are to be allocated over the number of accounting periods during which each item of assets renders

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* The words 'inflation', 'rising prices' are used synonymously.

service. Viewed from this angle, it is an allocation of *expired cost*. So, its exclusion will certainly exhibit a distorted picture of the revenue statement. (b) If these assets are not depreciated, the balance sheet which incorporates the historic costs of these assets, will not show the "true and fair" view of the state of affairs since the values of the fixed assets will not be reduced to the extent of consumption effected during the accounting period. It may be mentioned that like current assets fixed assets are also consumed but they are consumed in part in each operating cycle. (c) If a fund is not created by providing for depreciation each year and the entire operational profit is distributed, fresh capital might have to be introduced at the time of replacement of the asset.

As a remedy to the above problems, the system of providing for depreciation in accounts had been recommended. But it provides a temporary relief. Relief is temporary because based on a static price level depreciation is calculated using historic cost of the assets and this creates a number of problems including 'replacement'. It is a fact that prices have increased rapidly not only in our country but in many other countries of the world. Consequently, the disease spreads with all its symptoms and it creates a number of problems. The first problem results in incorrect determination of profit owing to matching of past costs against current revenues while the second one leads to distortion of balance sheet for obvious reasons. The third problem is the inadequacy of the depreciation fund accumulated by providing depreciation on the basis of historic cost and the salvage
value, if any, for replacement of the existing asset. It is needless to mention that the accumulated amount will fall short to the extent of the difference between the current replacement cost and the fund available (i.e., historic cost + salvage value + interest on investment, if any) for the purpose.

In such a situation, if replacement is unavoidable (indeed, replacement is a must in case of going-concerns as most of the items of fixed assets will not have perpetual lives), the deficit fund has to be collected by exploring various sources which may be broadly classified into two categories as follows:-

\[
\text{(Replacement Cost - Fund available)} = \text{Deficit Fund}
\]

- Financing from External sources
- Financing from Internal sources (i.e., working capital source)

If financed from external sources it will have an adverse effect on Return on Investment (ROI) if other things remain constant.

Replacement of fixed assets may not always enhance the earning capacity of an enterprise. But in all cases the capital employed will be increased by the amount of

2. ROI is known as the relation of profits (before or after tax) to capital employed. Although there are various interpretations of the term 'capital employed' it may be taken as the sum of fixed assets plus working capital. Alternatively, it may be taken at equity plus long-term debt capital.
additional fund collected from external sources. This will reduce the ROI. Alternatively, it can be financed from working capital source ; in that case, "either the volume of inventory has to be sacrificed or additional working capital will have to be added" by resorting to financing from outside again. So, basic problem of maintaining operating capability of the enterprise remains the same. External financing may appear to be the more appropriate remedy to maintain a given scale of operation. "If only the original money capital is maintained in the profit-determination process, when prices are rising, borrowing might have to take place to maintain the same volume of assets and the same volume of business."4

So far we have considered the problem of replacement of depreciable fixed assets. Replacement of inventories will also face similar problems. All sorts of inventories, e.g., "saleable", "convertible" and "consumable",5 are generally valued conventionally according to the principle of 'cost or market price, whichever is lower'. This principle is based on the accounting conservatism, i.e., all possible losses are taken care of but anticipated profits are ignored. During inflation, there is hardly any scope for valuing inventories at market price as past costs are always 'lower than market price'. Of the various cost methods e.g., 'Unit


cost', 'First-in-first-out', 'Last-in-first-out', 'base stock', 'average cost', 'standard cost', and 'reverse cost', adoption of first-in-first-out (FIFO) method results in valuation of closing inventories at the cost/s of latest purchase/s. But costs of goods sold are being valued at earlier costs, which are matched against current revenues. So only historic costs are realised.

But since during the realisation, prices of inventories generally go up along with the general rise in price level due to inflation, the realised historic capital will be simply inadequate to replace the same volume of inventories necessary to maintain even the same volume of business.

To illustrate the problem, let us assume that a trading concern having no opening stock, purchased 100 units of trading goods at a cost of Rs. 10 each. After another 6 months, it had to purchase another lot of 50 units @ Rs. 12 each. It is found at the end of the accounting period that it could sell only 150 units and realise Rs. 1700 in all. If the cost price of the goods at the end of the accounting period was Rs. 14 each, the position under conventional accounting will be as follows. Out of the cash realised (Rs. 1,700), only Rs. 1,240 is available for replacing the goods. Even to maintain the present volume of business (150 units) which requires procurement of 150 units (assumed) to avoid stock out position, at least 150 units of purchases are necessitated. It will require minimum Rs. 1,980 as against available fund
Revenues (120 units) realised 1,700

Less Cost of goods sold:

Purchases:
100 units @ Rs. 10 = 1,000
50 units @ Rs. 12 = 600
1,600

Less Closing stock:
(Using FIFO)
30 units @ Rs.12 = 360
1,240
Gross profit = 460

of Rs. 1,240. Thus, if the same volume as before is to be maintained, additional capital from outside will have to be injected into the business. Alternatively, the volume of business will have to be sacrificed. This is due to the fact that the cost of sale was under-charged by adhering to the original historic costs. Therefore, it may be seen that replacement of inventories may lead to same type of problem as replacement of fixed assets may warrant.

2. Incorrect Performance Evaluation

In times of inflation, the profit (or loss) figure as revealed under conventional or historic cost accounting is often over-stated (or under-stated). It may so happen that the profit and loss account is showing profit under historic cost accounting even when the business is running at a loss when impacts of rise in price level is incorporated in accounts. In fact, the revenue statement under

conventional accounting has serious limitation. H.W. Sweeney called it 'Vegetable accounting'. It permits algebraic summation of figures measured at different units. For example, purchases made at the beginning of an accounting period are added to those at the end during which time the value of money might have been changed. "It is just as inconceivable to add monetary units of different values as it is to add oranges and wood pulp." Since the purchasing power of money, defined as certain amount of goods and services which a unit of money can command or purchase, falls with the rise in price level during inflation, profit (or less) is generally overstated (or understated) inasmuch as the recovery of costs, both direct e.g., cost of materials, wages, etc. and indirect e.g., factory overhead including depreciation, administrative overhead and selling and distribution overhead, is made at lesser unit of purchasing power out of revenues. Again, revenues which are often considered to be measured at current purchasing power unit are earned at different points of time commanding different rates of purchasing power. Needless to reiterate, that these are inconceivably aggregated. "Grade-school tests are marked wrong when such nonsensical arithmetic is discovered, but accountants have been paid well for years for performing similar arithmetic."  

Depreciation and cost of goods sold have been considered to be "the most drastically affected item on the operating statement" because of their involvement in the values of currency at different points of time depending upon when the various depreciable assets were acquired and the costs incurred.

Professor Paton had no hesitation to describe the accounting profit of a concern as "invalid", when it fails to recoup the purchasing power invested in the process of production and sale.11

Another important misconception in profit determination under historic cost accounting is to consider monetary assets and liabilities as uncontributive. "Monetary items" e.g. monetary assets and liabilities, "have been defined to be assets, liabilities or capital, the amounts of which are fixed by contract or statute in terms of money value, regardless of changes in the purchasing power of the money."12 The examples of such monetary assets and liabilities are : Cash, debtors, creditors, bank overdraft, etc. In fact, if profit is considered to be certain amount of purchasing power, mere holding of

10. Accounting Research Study No. 6, Reporting the Financial Effects of Price-Level Changes, p. 24 (Quoted from E.S. Gynther, Ibid.)
monetary assets for some period will certainly lose some purchasing power during inflation and, conversely, holding of monetary liabilities will contribute to purchasing power gain. From this aspect it will be a wise move to minimize monetary working capital (i.e., monetary assets less monetary liabilities) during inflation. Since purchasing power of money, as defined earlier, means the amount of goods and services which can be purchased by a unit of money, naturally, a certain amount of money cannot command same amount of goods and services at two different points of time if the prices of goods and services tend to change. A certain amount of idle monetary assets, e.g. cash, will certainly command over lesser amount of goods and services at the end of the period than it could at the beginning since there is an upward change of prices over period during inflation. That is, it is losing its command or purchasing power. Conversely is the case of holding monetary liabilities. The present system of accounting does not recognize this gain or loss and fails to provide any method to identify them.

3. Insidious Effect of Incorrect Performance Evaluation and Capital Erosion

From the above discussions it has been undoubtedly established that financial reporting is highly distorted if adjustments for increasing prices are not made in the financial statements. Profit is highly overstated, rate of return on capital employed is inflated, fixed assets are undervalued, depreciation charge is far less than that would have been allocated taking the current cost into account,
capital is eroded by way of higher payments on account of dividend, bonus, etc. Thus the overstatement of profits leads to suicidal effects which have important bearing on the maintenance of real capital. This is discussed below in short.

(a) Payment of dividend: Inflated profit may lead to inflated divisible profits. That is, the amount of dividend paid to shareholders out of inflated divisible profits will be in excess of what ought to have been paid out of real profit. Payment of dividend much in excess of what ought to have been justified, therefore, leads to payment out of capital contravening the provisions of Section 205 of the Indian Companies Act. It leads to ultimate erosion of capital and thus the shareholders may miss the hen for the egg. This problem is discussed at length in chapter 3.

(b) Taxation: Higher amount of profit involves higher amount of tax for attracting higher tax slab. Payment of tax in excess of what ought to have been paid also leads to payment out of capital. "A high direct taxation of enterprise profits which disregards the accounting implication of changing money values not only damps down progress but can encroach upon business stability at exist-


* Sec. 205 of the Indian Companies Act provides that dividend is to be paid only out of profits.
ing levels of productivity."^{14}

(c) Profit-based remuneration: Sometimes, managerial remuneration is based, either in full or in part, on profit. Consequently, higher accounting profit leads to payment of higher remuneration to them than they are otherwise entitled to.

Payment of dividend, taxation or profit-based remuneration, as hinted above, much in excess of what ought to have been justified undoubtedly leads to, what is generally called, erosion of capital. The various aspects of capital erosion have, however, been taken up in chapter 3.

4. Misinterpretation of Financial Statements and Decision Making

One very important objective of accounting is information generation and supply of the same for making economic decisions. Accounting information is needed both for internal consumption for decision making purposes by management and also for external users e.g., creditors, shareholders, prospective investors, various financial institutions, etc. The latter category of user-groups may preferably be termed as 'non-management users'.^{15} Many important information are contained in the profit and loss account and the balance sheet. The interested users often have to take many decisions on the basis of the information obtained from the conventional financial statements. For example, creditors

15. L.S. Porwal, op. cit., p. 312.
frequently judge the liquidity position of the enterprise, before allowing further relaxation in credit terms based on information available from published accounts; prospective investors are interested as to the security of their investment and the expected return. Even the general public may be interested about the cost and the profit. Since every enterprise has to operate within the society and uses resources of the society for carrying on its operation, the enterprise is, in turn, expected to fulfill some social responsibilities. Supply of information to aid meaningful decision-making is one such social responsibility. With this end in view, the Companies Act of many countries like India, U.K., Pakistan, Australia, etc. provide rules and format to prepare the profit and loss account and balance sheet. For example, the Companies Act requires the companies to prepare accounts so as to represent the "true and fair" view as will be evident from the provisions of Sec. 211. Section 211 of the Companies Act provides that 'every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year' and 'every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year'.

But during inflation even if the accounts are prepared strictly in accordance with the statutory provisions, both the financial statements may not satisfy the 'qualitative' norm prescribed in section 211 of the Act. For example, the profit and loss account may fail to satisfy the 'true and
fair view' concept because it contains two elements:
(a) earned profit, and (b) unearned profit. Needless to mention, the unearned profit is the result of:

(i) Under-charging of depreciation, and
(ii) Under-recovery of other items of cost of goods sold.

It has been stated earlier that the elements of cost of goods sold, whether material cost or non-material cost, are but recorded at historic costs each of which are far less than their relevant current costs which have gone up due to rise in price level. This being matched against revenues, leaves a portion of the current costs unrecovered leading to overstatement of profit, as already stated.

Whether the balance sheet will meet the requirement of revealing the exact financial position is dependent on the fairness of the valuation of assets and liabilities. Under historic cost accounting current assets are generally valued at recorded nominal value or at market value whichever is lower. We have seen how they, particularly inventories, distort operating results. On the other hand, fixed assets are either valued at cost (e.g., land) or at 'cost less depreciation' (e.g., plant, machinery, furniture, etc.). Valuation at historic cost or 'historic cost less depreciation' will mean, according to many academics, under-valuation of fixed assets in the balance sheet in times of inflation. Under such a situation balance sheet cannot be expected to depict the fair financial position of the enterprise. It therefore appears that even when corporate
accounts are prepared strictly in accordance with the provisions of the Act, the same may not only frustrate the requirements of Sec. 211 of the Companies Act, "namely, complying with the 'true and fair view' concept" but also violate the provisions of Sec. 205."

Mason summarises the position in the following words:

"In brief, then, without adjustment of the figures, the income statement suffers from price level changes by lack of comparability of the accounting figures, from the failure of depreciation and similar costs to reflect the current price level and therefore to be comparable with the current revenue figures, and from the resulting diminished significance of the reported net income. The balance sheet also suffers from lack of comparability of the various items. Cash and receivables and the unpaid liabilities are expressed in current dollars, but the inventories and especially the plant and equipment are collections of non-comparable items since they are almost always a hodge-podge of various past period dollars representing different amounts of purchasing power over commodities and services. The purchasing power gains and losses in the net monetary position are undisclosed. Stockholders and other investors are not provided with information which enables them to interpret the operating results and to judge the relative effect of price-level changes upon particular enterprise." 

Thus, if the figures contained in the basic accounts are not correct having regard to the price level adjustments required to be made, their subsequent use for decision making or for any other purpose may give faulty results. "There are many significant accounting ratios whose computation is vitiated by adherence to the historical cost basis of accounting. Decisions made in consideration of them are apt to be faulty." As for example, gross profit ratio, one of the indicators of profitability, may not be a true measure in this context. Rate of equity dividend is also inflated since instead of considering real value of capital nominal value is taken into consideration. Alternatively, the amount of dividend declared by the directors should be deflated in terms of the rupee value of the nominal paid up capital and then only a correct rate of dividend may be computed. Mutton very rightly pointed out that "it", the conventional unadjusted figure, "is mathematical nonsense to use the profits to funds ratio as a test of the worthwhileness of the business or the efficiency of its management. With the profit overstated and with the funds understated, the percentage reflects two errors both operating to overstate the percentage." There may also be objection to the method of showing equity share capital at its nominal paid up value.

instead of its real value on the balance sheet date. The position of preference shareholders is also not different. In fact, their rights are more adversely affected than the equity shareholders as preference dividend is calculated not on its real value based on the current purchasing power of money but as a fixed percentage on the nominal value of share capital. "So, with the rise in price levels, the same nominal amount of dividend represents more and more lower return in terms of real value and the balance of distributable profit that is left to be paid as dividend to equity shareholders consists of amounts every time more than what would have been otherwise payable." Thus, preference shareholders have to suffer to the benefit of the equity shareholders. But it may be argued that equity shareholders have to bear more risk for their investments than the preference shareholders. This risk perception increases during inflation. Although "the extent of the increase in that risk because of inflation has been far from clear in the accounts and financial reports" due to the risk involved, naturally, they may expect to be compensated by a higher rate of return for their investments.