CHAPTER - 5

CONCLUSIONS AND SUGGESTED PRACTICAL MODEL OF INFLATION ACCOUNTING FOR FUTURE USE BY CORPORATES IN INDIA.
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Conclusions and Suggested Practical Model of Inflation Accounting for future use by Corporates in India.

Introduction

In the preceding chapter we have studied the theory and practice of inflation accounting adopted by some companies in India’s corporate sector such as Ashok Leyland Ltd., Bharat Heavy Electricals Ltd., Carborundum Universal Ltd., and Voltas Ltd., besides foreign companies in the selected foreign countries. This chapter now attempts to draw some conclusions of inflation accounting and suggest a practical model of inflation accounting for future use by Indian Corporates. This has become possible on account of our study into the problems and prospects of this important tool of accounting in measuring the efficiency of an enterprise in these days of rising prices. We shall now venture to offer some suggestions for consideration by the Government, professional bodies industries and other users of financial statements. It must, however, be borne in mind that until now no method which is acceptable to all has been evolved. Our conclusions and suggestions to initiate the implementation of inflation accounting techniques are as follows.

Impact of Inflation on Financial Statements: Accounting for inflation has been under consideration for quite some time but the debate still remains inconclusive. Inflation is socially divisive. Individuals who have savings largely in money assets and who are weak
in wage-bargaining power become poorer, those who have real assets and have exercised their power to borrow and are economically strong become richer. Nobody should wish other than success to Government which attempt to restrain inflation, but they are unlikely to be able to eliminate it completely, and to the extent that some inflation is countenanced by some Governments, they should be prepared to reduce its divisive impact. Some movements in this direction can be seen from a proposal on tax on property development, schemes whereby the mortgage of house property receives an equity interest, the threshold provisions of the pay and prices policy. To compensate every situation where a person is at risk from inflation would undoubtedly reduce the strength of public support for anti-inflation policies, but it seems possible practice to draw a dividing line between the personal sector and the corporate sector. Inflation accounting in such situations is desirable move, particularly when it leads to a fairer distribution of tax between among companies which gain from inflation and those which lose from it. The problem is that the inflation adjusted accounts are not acceptable to many public authorities mainly taxation authorities. At the same time corporate laws in all the countries require the companies to present a “true and fair” picture of corporate affairs in their annual reports. Therefore, even the present day requirements of the authorities are changing. From the investors and creditors viewpoint, unless the publication of inflation adjusted accounts by the companies become the general practice, they have to make their own estimates of the impact of inflation on individual companies. During the past four decades there has been several proposals on how financial statements should be adjusted
to show the effect of inflation when there were violent fluctuations in prices. The
financial statements prepared on historical cost basis have become highly distorted.
Balance Sheet of a business does not reflect true value of assets and liabilities and the
profits of different periods become incomparable to the present day. Also, the
information disclosed by financial statements raised doubts regarding the soundness of
investment decisions during inflation and hampers the ability of investors, creditors and
others to derive useful information to make proper investment decisions and their
appraisal.

Fixed assets shown in balance sheet become a meaningless conglomeration of
resources purchased at varying costs in different years. The depreciation provision based
on the original money investment of fixed assets represents an amalgam of costs
incurred at various points of time and does not represent the same amount of purchasing
power as was originally invested in the assets exhausted during operations. With
inflation, the historical cost basis of depreciation widens the gap between the annual
depreciation provision and the cost of used up portion of assets. As a result, the company
face difficulties in replacing the assets. Moreover, the depreciation provision when
matched with sales at current prices leads to an inflated profit figure. In the balance sheet,
assets are recorded at historical cost basis instead of current prices. Similarly, inventories
are valued at their acquisition cost. Further, the historical cost of goods sold are matched
with sales revenue at current prices. This results in an inflated profit figure referred to as
inventory profit. Thus a time lag error is said to arise when an account sets off cost of one
price level against revenue of another and the size of the error is equal to the appreciation in historical cost between the cost date and sale date.

Inflation makes a monetary liability less burdensome. The purchasing power represented by claims of creditors falls during a period of inflation representing a gain to business. At the same time, on the other hand, there is fall in the purchasing power of a bank deposit or an amount due from debtors, thus representing a loss to business. These gains and losses are in the nature of costs of holding monetary assets and liabilities and should be taken into account while considering the effects of price changes on historical cost accounts. In fact, a favourable impact of inflation is the gain to equity holders due to the use of fixed charge securities in the capitalization of a company and corresponding decline in purchasing power to fixed charge security holders. Since most business enterprises had higher debt than internal equity in their capital structure there were purchasing power gains due to excessive monetary liabilities. Therefore, management based on historical cost is suspect right from the start and financial reporting over the year became ‘massively sick with the virus inflation’. If the effects of price changes events are ignored continuously in accounting, then we may soon find that financial reporting will have lost its usefulness and credibility. Therefore, there is a need for a suitable accounting system which can take care of the changing prices.

As regards approaches to inflation accounting, efforts made so far evolve a method of accounting for inflation have not succeeded. Attempts, are of course, being made in this direction. The primary reason for this situation seems to be a lack of clarity
regarding the objectives of collecting and supplying relevant accounting information. The FASB of USA has brought into sharp focus the objectives of financial reporting by business enterprises by issuing Statement of Financial Accounting Concepts (SFAC-1). During the past four decades, discussions have mainly centered around two broad approaches viz. the general purchasing power (general price level index) approach and the current cost (specific price) approach. During the sixties preference seemed to be for general purchasing power while during the seventies, some variant for current cost approach was generally advocated. Business enterprises were largely of the view that specific price should be the basis for adjustment for inflation in accounts because it maintained the operating capacity i.e., capital intact. This approach, of course, has many limitations – comparability, subjectivity, and understandability, being few among others. It is because of this that the concerned authorities in India are not adopting in toto the current cost account method as followed in U.K. The general purchasing power is found to be theoretically better and it would be used without much practical difficulty because this approach adopts a general price index hence the criticisms against the method do not hold much ground. Besides, the empirical studies undertaken and use of this method by companies to produce supplementary financial statements on an experimental basis have shown that this method can be used without much difficulty. Thus, the method has the advantages of objectivity, comparability and understandability among others.

As regards inflation accounting practices in some foreign countries viz. United States of America, United Kingdom, Canada, France, Belgium, Sweden, Japan, Germany,
Australia and Italy, we have come to the conclusion that the accounting for inflation has been in practice for quite some time especially during the last four decades. There have been several proposals on how financial statements should be adjusted to show the effects of inflation. These proposals are: in the U.S.A. SFAS-33 “Financial Reporting and Changing Prices” issued on September 1979 by the FASB. In Canada Section 4510 of Canadian Institute of Chartered Accountants (CICA) Hand Book “Reporting the effect of Price Changing” issued in December 1982 by the Canadian Institute of Chartered Accountants, Toronto. In Australia, Selective Exposure of Proposed Statement of Accounting Standard: “Current Cost Accounting Research Foundation, Melbourne. In the U.K. SSAP-16 “Current Cost Accounting” issued in March 1980 by the Accounting Standard Committee, London. The above proposals are not exhaustive but represents the serious effects made to come up with right answer for concepts and methods of adjusting financial statements for price changes.

The present position is that though there are very few countries which have officially adopted accounting for price level changes either as a superior substitute for historical cost accounting or supplementary to it but a general consensus is yet to be obtained as to the proper Accounting for Price Level Changes standard to be perused. Obviously, there was never a consensus on any one method. In fact, this has been the greatest hurdle in the way of almost of every country thinking of introducing some system of inflation accounting.
The need of inflation accounting in India's corporate sector is felt invariably by all and sundry, though only a few companies viz. Ashok Leyland Limited, Bharat Heavy Electricals Limited, Carborundum Universal Limited and Voltas Limited used inflation accounting methods either current cost accounting method or general purchasing power method. But there is no unanimity among the respondents regarding the methods of inflation accounting they would like to recommend for adoption in India. Some preferred current cost accounting others has a choice for general purchasing power accounting, some liked a combination of the two methods, while majority felt that the inflation accounting was not relevant hence the choice of method does not arise. The above-mentioned companies under study responded that they have used the inflation accounting methods just to know the impact of inflation accounting and for information purpose only. They are not intending to do the same in subsequent years. The greatest obstacles in the way of adopting inflation accounting are: practical difficulties in its implementation, non-acceptance of final accounts for tax purposes and difficulty in understanding such accounts. Inflation accounting by and large is done for management use only. The basic objectives of financial reporting does not seem to be considered significant in India. It is, therefore, desirable to introduce inflation accounting in the Indian business, although the reasons given by the respondents to support the use of inflation-adjusted information differed a lot.
Suggestions

In view of the above analysis and discussions, the following may be suggested as points to be adhered to while adopting a system of inflation accounting.

First of all, there is a need to set up a high level committee. The problem of changing prices is going to stay more or less permanently. Consequently, serious efforts should be made by all concerned to evolve a system of accounting that can take care of both inflation and deflation. Accounting system is a function of legal, social, political, economic, and other types of environment prevailing in a country. We need a system of accounting, which can meet the present and future needs of all types of users as also of the society. Professional bodies and academics have an important role to play in shaping the accounting system. In the U.S.A., the U.K., Canada, Australia and France and many other countries, professional bodies have been doing a lot in this regard. In India also, the Accounting Standard Board of the Institute of Chartered Accountants of India (ICAI) and Institute of Cost and Works Accountants of India (ICWAI) have been issuing standards. Fifteen standards have been issued so far, which are almost wholly based on International Accounting Standards. India has a dominating public sector. Its requirements have also to be kept in view while issuing standards in India. It is suggested that a committee on the pattern of Accounting Standards Committee (ASC) of U.K. or Financial Accounting Standards Board (FASB) of U.S.A. should be formed in India. Such a committee should be representative body of financial accountants, cost accountants, management accountants, government accountants, public sector accountants and leading academics in
the accounting area. This Committee comprising of accounting professionals, intellectuals and social thinkers should engage itself into studying the problem and came out with remedies and important in the system of presenting accounting inflation with view of in computing inflationary trends in the data.

This committee should issue statements and guidelines which meet the requirements of India. Unlike the developed economies where such accounting bodies are strong, and make their voice heard by the Government, the proposed accounting committee in the developing economies will need government support, with out which the recommendation of such a committee will not be effective. In order to provide managerial and administrative tool for maximization of socio-economic progress, this committee on the pattern of Sandilands Committee in U.K. should like into the standardization of concept, practices, terminology and technology of valuation accounting. The committee should also coordinate the activities of all the accounting bodies and association in this context and jointly issue a statement of standard accounting practice requiring the companies to follow the standards of current cost accounting as soon as possible.

Secondly, the Government Statistical Organization should publish monthly, without such delays, a new series of price indices specific to particulars industries for capital expenditure on plant and machinery by these industries in order to provide a standard reference basis, for current purchase price (Replacement Cost) of fixed assets other than land and building, for motor vehicles there should be a separate index. In case
where no specific indices are available the indices to be used for valuation of corporate assets should have prior approval from the auditors, tax authorities, shareholders, SEBI and other bodies. The revaluation should become regular feature but where the cost of revaluation is higher, it could be done at an interval of 3 to 5 years.

Thirdly, the auditing profession should review its responsibilities from time to time in view of the certification regarding 'true and fair' and also the new horizons of their profession recently opened and recognised like social audit requirement in India. In order to gain exact information of the true profit situation all enterprises engaged in industry and commerce, and other enterprises with significant non-monetary assets, determine at least for internal purposes the amount of profit that is required to preserve the operating capacity capital of the enterprises, and thus for the continuation of the enterprise and the security of its jobs. The results of this exercise may be disclosed in directors' annual reports to shareholders. Companies should show the 'value to the business' of their plant and machinery by reference to the appropriate official index, and should state in a note to the accounts the reference numbers of official index or indices used, unless the directors consider that a different basis of valuation is more appropriate and is likely to provide a more precise figure. In that case the directors should show 'the value to the business' of the assets concerned on the basis the directors consider appropriate subject to certain safeguards and, further, where a change in the basis of valuation is made, the fact should be mentioned in the note and the change should be done only in consultation with the auditors, revenue authorities and shareholders.
Further research needs to be carried out on the techniques of valuing stocks, especially the work-in-progress. In case of overseas operations, the valuation of assets held overseas should be assessed to their actual location and the basis of such valuation be disclosed in the accounts and should be approved by the auditors. The translation of results of overseas operations should be done after drawing up the accounts of those operations on a Current Cost Accounting basis. Marketable securities should be shown in the Balance Sheet at their market value. The net book value of assets on a historical cost basis and the historical cost depreciation should continue to be shown in the notes to the accounts. The annual accounts should include a funds flow statement and the directors be required to give a statement on the adequacy of the cash and other liquid resources likely to become available to meet the company's requirements in the ensuing years. Land and building should be valued on the 'existing use' basis, and where these represent a material element of a company's assets, valuations should be prepared with the advice of independent valuers. The valuation process should consist of ascertaining to what extent changed circumstances have influenced the previous estimates. Companies which are in a position to ascertain the current cost of each sale at the time it is made, should in future use these figures as the basis of the charge for cost of sales in their Current Cost Accounts. Other companies should calculate a 'Cost of sales Adjustment' by applying 'averaging method' and show the calculations separately in the Profit and Loss Account. Depreciation should be provided on all fixed assets except land and the backlog depreciation should not be changed against the Profit and Loss Account. In case where
the basis of valuation of an asset is changed during the year, the depreciation should be calculated on the basis of the value shown in the Balance Sheet at the end of the year. Current Cost Accounts should be presented in such a way that all 'holding' and extraordinary gains' are distinguished from 'Current Cost Profit'. Unrealised losses should be written off against Revaluation Reserve. A summary Statement of Total Gains or losses for the year along with a statement showing the increase in purchasing power of shareholders' funds should be presented in the annual accounts. In the longer term it is recommended for the companies to present a 5 to 10 years-summary table in the form of ratios. When fixed assets are revalued in accordance with the principles of Current Cost Accounting, amounts for deferred taxation should be provided from the Revaluation Reserves. Finally, for the utilization of the available technology of inflation and valuation accounting as a managerial tool for fighting inflationary trends, there is an urgent need for change in the methodology of business accounting, under inflationary trends. For evolution of managerial tools, leading to maximization of productivity and optimization of profit for maximization of socio-economic welfare of the ‘people’ as well as improvement in the status of their ‘happiness’ the accounting profession has to work continuously for presenting, analyzing, and interpreting the accounting data in an improved form. This will involve the departure from conventional accounting practices, and change in the outlook, thought-processes and behaviour pattern of accountants, in all walks of life. Delay in development and utilization of this technology is likely to lead to considerable erosion of credibility in the integrity of the accounting profession by
managers, administrators, executives, investors, creditors, government agencies and
others. In view of the high rate of inflationary trends throughout the world, therefore, the
need for early development and utilization of the available technology of inflation
accounting is highly significant and urgent. The implementation of the above
recommendation, emanating from this survey and analysis of the area of valuation of
corporate property and inflation accounting, will go a long way in meeting the current
and future needs of presentation and disclosure of vital financial information in company
reports and will provide much needed realisation of the price level changes in the
economy and their impact on company operations, management, liquidity and solvency.

The Future Direction of Inflation Accounting: Inflation accounting sometimes has
over tones of a crusade and I want to conclude this chapter by trying to place it in a more
realistic perspective. Continued inflation is rendering historical cost accounting obsolete.
The general price level has doubled in the past eight years and at the current pace will
double again in the next eight. Current cost accounting is conceptually a better
measurement system under these conditions but there are practical difficulties in costing
some types of assets. The replacement cost method of pricing is well understood and
accepted for inventories because the turnover time is short and new purchases quickly
provide new prices. Fixed assets, which are often unique or special purpose structures
with long lives, are more difficult to price each year. Technological change may
introduce other problems. Nevertheless, as businessmen and accountants continue to
develop current cost data, accuracy will improve.
Inflation accounting can aid economic decisions by providing better measurement and eliminating some of the euphoria that is generated by inflation inspired historical cost results. But it is not going to change the basic thrust of most of these decisions because the fundamental content of accounting statements will tend to be the same under either method. Sales are the same, and most costs and expenses are the same and cash flow is the same, current cost accounting separates operating income and holding gains and this becomes more important to capital maintenance as that rate of inflation rises.

Factors in user adoption: Investors and analysts have been slow to adopt inflation adjusted financial statements because the additional information they provide is viewed as marginal compared with all other factors that affect company earnings and financial position, management, markets, new products, competition, labour costs, etc. Adopting new financial measures is analogous to learning to convert from gallons to liters at the gas pump: we continue to translate liters back to gallons until eventually we get used to metric measures. Likewise, the advantages and insights provided by current cost accounting will become better understood, more data will become available, and communication about financial statements will gradually shift from the old to the new system.

Inflation accounting will have to deliver different messages than historical cost accounting from time to time and these messages will have to prove meaningful. If the trend of current cost earnings merely parallels historical cost earnings at a lower level, they will not add much information. That was the composite pattern between 1976 and
1979. The 1973 - 1975, or possibly the 1980, divergences provide opportunities for current cost earning to provide their value.

The future course of inflation will determine the pace of adoption. If the administration's current monetary policy persists for another two years or so, we should see a much lower rate of inflation and the impetus for a change in accounting will lapse. But if the current rate of inflation continues, interest in current cost accounting should accelerate.

**Suggested Model**

In view of the study made in this dissertation I would like to suggest the following standard model for inflation accounting for future use by corporates in India.

1. All companies should adopt accounting for inflation so that they can constantly monitor whether or not they are maintaining their real capital.

2. The system of accounting for inflation should be so designed that the accounting measurements generated by it are useful to the internal as well as external users. If it is feasible for the management to publish these measurements with their annual balance sheets, they must publish it. However, it must be carefully reviewed before publication so that the supplementary information is technically sound and is useful to its users. This would be vouched by an independent auditor.

3. In view of the fact that the application of general price level adjustment method is valid, it is recommended that all enterprises in India should use this
method to account for price level changes. The Government agencies and other bodies should undertake the task of preparing and publishing the indices of various types which could be for this purpose. The enterprises should build up their accounting system in such a way that the balance sheet for present year indicates the value of assets on current purchasing power and not on historical or written down value.

4. To provide information partially in notes appended to financial statements or as supplements can only be a temporary solution. In the long run, the effects of material price change events will have to be recognised in the basic accounting model if financial reporting is to be useful in decision making.

5. After proper empirical experimentation the feasibility of substituting allocation basis of accounting with cash flow accounting should be examined over the long run for reason cited earlier.

6. The government should, in the general interest of the public, take immediate steps to ensure that the enterprises maintain their maximum capacity. It can be achieved by retaining differences between historical cost profit and general price level profits.

7. To facilitate the true and fair comparison between the different enterprises over the years or within the enterprise over the years, the accounting for inflation should be used.
The researchers should develop the various tools and techniques in the same manner as are developed by the foreign scholars. The accounting bodies of India should also build up a standard for shielding the impact of inflation on historical accounts.

Although a Guidance Note for Accounting for changing prices has been issued in December 1982 by ICAI, it was recommendatory in nature and did not have much impact on preparers or users. Moreover, its recommendations were limited only to corrective steps that should be taken to rectify. The distortion of items on which the impact of inflation is significant until the development of full fledged current cost accounting system was missing and hence these points should form the basis of inflation accounting practices in future.

A Board of Committee should be set up by the Government in which members should be academicians, professional accountants, representatives of central Board of Direct taxes and the Company Law Board, Trade Unions, Stock Exchanges, Chambers of Commerce, Shareholders, Associations Bankers and Financers. These members should give more attention for the developments of this subject so that the maximum benefit could be derived by the users of financial position statements. They should also provide more techniques on this subject enabling to fight the inflationary pressures on the accounts of enterprises.
Finally, the solution to the problem of inflation accounting should not be on an adhoc basis. In fact, we should make efforts to devise a method of accounting which has a built in mechanism to adjust to changing (increasing or decreasing) prices. This method should be sound in theory and help the users in making rational economic decisions. An effort has been made during the past decade by some well-known academics and professionals to examine the possibility of adopting Cash Flow Accounting (CFA). It is claimed that the proposed Cash Flow Accounting, besides taking care of most of the shortcomings of the General Purchasing Power Accounting and Current Cost Accounting, provides good indicators of liquidity and performance of a business enterprise which are essential for making wise investment decisions. It automatically makes adjustments for increasing or decreasing price and has a proper rationale. The cash flow accounting should appear as supplementary statements to the conventional accounts of an enterprise. As time passes and the users of financial statements gain sufficient knowledge about the usefulness of cash flow accounting information, the conventional profits and loss account can be dispersed with and replaced by a statement of cash flow. Certain modification to the historical cost balance sheet would also be necessary to introduce cash flow orientation into the position statements.