ABSTRACT

Accounting is a service activity. Its main purpose is to provide quantitative financial information for decision making in a business. The accounting activities form a progression of steps beginning with observing, then collecting, recording, analysing and finally communicating information to its users viz., creditors, investors, Government, trade unions, management and researchers etc. Such financial information is usually reported to the various users through the financial statements which are prepared based on certain accounting concepts and conventions. The existing accounting practice of preparation of financial statements are based on an important accounting concept namely the monetary concept. Money is common measuring unit of transactions which are recorded in the books of account. Only those transactions which can be measured in money are taken into consideration. But with the change in the value of money due to inflation the assumption of a stable monetary unit does not hold good and creates a number of problems in the preparation of accounts in various ways. Thus the subject of inflation accounting now a days has received a wide attention in financial accounting due to inflation prevailing in many countries in the world. This has attracted wide attention in financial accounting in the last few decades. The term ‘inflation’ which means either an increase in general price level or decrease in purchasing power of money came into use in the latter half of the 19th century and into general use in about 1915 during the First World War. In India, it was started in the beginning of the Second World War. Therefore, the inflationary trend has become one of the realities of economic life. The economic activities of business are recorded by the present historical cost accounting system that
applies money as the common scale of measuring all activities. As the money scale of measurement is continuously undergoing changes, the financial statements prepared on historical cost basis presented a highly distorted view of the income and financial position of business concerns. Income is highly overstated with the result that higher taxes, bonuses and dividends are to be paid. This resulted in erosion of capital of a company. Inventory is not realistically valued. Fixed Assets shown in the balance sheet become a meaningless conglomeration of resources purchases at varying costs in different years. Depreciation charge was for less than it should have been. The inflation-affected financial statements hampered the ability of investors, creditors and others to derive useful information to make proper investment decision. As a result a feeling is cropping up in India among accountants, members of professional bodies, research organizations and academics that keeping in view the drawbacks of historical cost accounting, there is a need to restructure historical cost based financial statements for accurate measurement of profit and reliable reporting of financial position. Inflation adjusted financial statements would not only achieve the objective of reliable profit and financial position measurements but would also prove useful to managements and external users in their decision-makings. Inflation accounting is a generic expression connoting any of the phrases likes accounting for prices level Changes (APC) price level accounting, replacement cost accounting, current cost accounting (CCA), general purchasing power accounting (GPPA).

H.W. Sweeny in his publication known as Sweeny's Stabilised Accounting published as early as 1936 in West Germany studied Inflation Accounting as a systematic
way in the early part of this century. In his publication he proposed an accounting technique to deal with changing price level.

A study conducted by the American Institute of Certified Public Accountants (AICPA) in 1948, felt that no basic change in the accounting treatments of depreciation of plant and equipment is practicable under present conditions to meet the problem created by the decline in the Purchasing power of dollar. The AICPA in 1963 advocated inflation accounting very seriously in a study entitled "Reporting the Financial Effects of Price Level Changes". About six years later, the accounting Principles’ Board of AICPA published its Statement No.3 in June, 1969 on Financial Statements restated for general prices level changes. The Financial Accounting Standard Board (FASB) was formed in 1973. It prepared a few exposure drafts and brought out some standard most notables among them is Financial Accounting Standard (FAS)-33 issued by it in 1979. Besides, the Securities and Exchange Commission (SEC) also contributed to the discussion by issuing ‘Accounting series release (ASR) 190” to provide additional information on the estimate cost of replacing the inventories etc. Until very recently SFAS-33 was emerging as the correct accounting for price level changes (APC) standard in the U.S.A. But in December 1986 another Standard was issued entitled SFAS-89 by the FASB, which emerges as the latest APC standard in the U.S.A.

A study conducted by Institute of Chartered Accountants in England and Wales published in January 1973. As a companions to the Exposure draft (ED 8) on “Accounting for Changes in the Purchasing Power of Money” issued by the Accounting Standard Steering Committee (ASSC). The Exposure Draft (ED 8) was debated at length
and in May 1974 it was followed by ASSC’s Statement of Standard Accounting Practice (No. 7 in a series of SSAP’s). This document, provisional in its nature, required the quoted companies to provide inflation adjusted accounts prepared under historical conventions.

Sandilands, F. E. P., in his report known entitled “Sandilands Committee Report” London 1975 studied that the first recorded statement on Accounting for Price Level Changes (APC) in the Accounting principle No.12 released by the Institute of Chartered Accountant of England and Wales (ICEAW) in January 1949. After those may statements and standards were issued on the subject till the inflation accounting committee was appointed. The Government of U.K. setup a Inflationary Accounting Committee in January, 1974 under the Chairmanship of F.E.P. Sandilands the then Chancellor of the Exchequer in the United Kingdom The object of this Committee known as Sandilands Committee to study the effect of the inflation on accounts and suggest remedial measures. The Sandilands Committees presented its report to British parliament in 1975, and recommended the current cost accounting (CCA) a the device to reflect the affects of inflation, Based on Sandi lands committee Report, the Accounting Standard Committee (ASC) issued Exposure Draft 18 in November, 1976. ED-18 required the companies to give inflation-adjusted accounts in the primary financial statements, however due to some technical flows Ed-18 was shelved and fresh discussion started in this regard. Then accounting Standard Committee appointed a committee popularly known as Hyde Committee in 1977. The Committee issued the guidelines known as Hyde Guidelines “ in 1978. In 1979, it was proposed that "Hyde Guidelines" should be made mandatory.
Baxter W. T., in his book entitled "Accounting Value and Inflation" McGraw Hill U.K. 1975 discussed that accounting grew up as a day by day record of business dealings. Its figures are a series of snapshots, each a glimpse of some event as it happen.

An article entitled “Current Cost Accounting -Some Basic Problems” by Fisher, John published in U.K. 1976 make a comprehensive study of Accounting Price Level Changes (APC) standard is SSAP-16 which was issued in March 1980. Although it is mandatory and calls for a complete set of current cost statements including an income statement and balance sheet many companies have shown reservation in complying with it. Despite very high degree of resistance or reservations shown by the companies it survived because it (SSAP -16) has many strong points in favour of it.

Walter B Meigs and Robert P. Meigs in 1983 in his book entitled "Accounting- the basis for Business Decisions" discussed on "Inflation - The Greatest Challenge to Accounting" they define inflation as either an increase in the general price level or a decrease in the purchasing power of the money (Dollar). The general price level is the weighted average of the prices of all goods and services in the economy. Changes in general price level are measured by general price index with a base year assigned a value of 100. The index compares the level of current prices with that of the base year.

An article entitled “ The Inflation Accounting Cycle: A British - Australian Comparative Perspective by Burrows, G./ Rowles, T. in 1998 This paper seeks to extend understanding of the ‘accounting-cycle’ hypothesis by comparing the Australian, and United Kingdom (UK) experiences with inflation accounting. The existence of ‘cycles’ in
accounting standard setting was first suggested in respect of inflation accounting by Mumford (1979), and subsequently generalised by Nobes (1991).

Gupta Ramesh in 1976 in his book entitled "Inflation Accounting" explain that the SSAP-16 came into effects since January 1, 1985 and is applicable to all the listed and unlisted companies except those small nonrealistic companies which satisfy at least two of the following three criteria namely (a) turnover is less than $ 5 million per annum, (b) balance sheet total in historical cost accounts at the beginning of the period is less than $250000, (c) average number of employees is less than 250.

Porwal L.S., and Mishra, N., investigated into corporate practices in inflation accounting in India. They approached 235 large private and public sector companies in India through questionnaires sent by mail and through personal interviews. 80 companies out of 275 companies responded to their study, which is 34 per cent of the total sample. These companies were from all-important industrial groups like trade, finance and others, and were scattered all over the country, i.e., a fairly representative study. The study was mainly divided into two parts. First part investigates the need felt by corporate managers for inflation accounting and the second part deals with a study of the inflation accounting practices adopted by some of the responding companies.

Nigam, R.S., Delhi School of Economics (1983) surveyed the Inflation Accounting in the Developing World. He noted that in the developing world, in Trinidad and Tobago, some serious efforts have been made in recent years and a high level committee (popularly named after its Chairman Mr. Joseph Punder) was set up by the Cabinet on September 22, 1977, with the following terms of reference.
Parchure Rajas 1987 in his book entitled "Inflation and Accounting Theory" observed that the inflation accounting is a subject which gained widespread use in US, UK, Canada, Australia, the Latin American and the Scandinavian countries. In India too there has been a continuing discussion on this subject in which accountants, economists, industrialists and the government have participated.

Vemonkam in 1990 his book entitled "Accounting Theory" they discussed inflation accounting. He defined the term inflation which is usually understood by the people to mean an excessive rise in price.


The Inflation- Accounting itself is neither homogenous nor unanimous but their front against historical cost accounts is a united one. There are two alternative approaches to modifying our accounting process to cope with inflation have received much attention. One is to adjust historical cost figures for changes in the purchasing power of the monetary unit and the second is to use current values instead of historical cost in preparing financial statements. The former is a pure scale adjustment for changes in the measuring unit i.e., the purchasing power of the rupee and known as the current purchasing power method. The second involves regular valuation of assets and deals with specific price changes of individual items held or dealt with by the firm. This method is known as current cost accounting (CCA). These two approaches enjoy the majority adherents. Also, the real replacement cost accounting method is a middle- of- the road
approach based on replacement cost accounting and general purchasing power accounting. Another approach that has lately emerged on the accounting horizon is the cash flow accounting. All these approaches are different in substance and in technique from one and another.

The origin of purchasing power accounting is usually traced to H.W. Sweeney, in his book Stabilised Accounting first publication in 1936. Since then a large number of individuals and institutions have worked on the method with a view to developing it as a useful and practicable method of price level accounting.

This method is also called by different names such as General Purchasing Power Accounting (GPPA), General Price-Level Accounting (GPLA) or Constant Rupee Accounting and Constant Dollar Accounting (used in U.S.A.). The objectives of this method are to show the affairs of a firm in terms of a unit of measurement of constant value when cost and prices are changing. The purchasing power accounting method drives theoretically from the rule that the profit of a firm should be so computed as to maintain intact the purchasing power of the shareholders capital originally invested in the business. The method involves expressing historical cost accounts in terms of purchasing power units rather than money. Thus, the methods eliminates the effects on account of changes in the value of money.

The required adjustments are made on the assumptions that each and every transaction takes place evenly during the year i.e., at the average price level of the year. Average price index is calculated by taking the average of the index numbers at the
beginning and at the end of the period in case information regarding average index is not available.

General Purchasing Power refers ability to buy all types of goods and services available in the economy and it is measured by changes in the general price level based on approved general price index at a given date. A price index here means a ratio that express the relationship between the price of a given object (or service) at a specific time and the price of the same object during a period selected as a base year assigned a value of 100. For example, if a building has been purchased on January 1, 1985 for Rs. 50,000 when the general price index was 100. The general price index of January 1, 1990 was 200. Here the cost of building in terms of rupee on January 1, 1990 would be Rs. 1,00,000 (i.e., 200/100 x 50,000). Thus, the general price level adjustment restates financial data by bringing past rupee amounts in line to current rupee purchasing power by general index multiplier or conversion factor which measures the relationship between the current price index and the price index at the time of acquisition of the asset. This can be expressed by the following formula:

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\frac{\text{Average price index for current year}}{\text{Index at the date of historical cost}} \times \frac{\text{Historical cost}}{\text{Equivalent number of current rupee}}
\]

Current Purchasing Power Accounting (CPPA) provides necessary information regarding purchasing power gain and loss resulting from holding monetary items to the management for decision making. Besides, this approach removes the shortcomings of money as a measuring rod during inflation and seeks to remove the negative effects of
changes in the value of the rupee. It does not consider changes in the specific prices. Finally, this method is simple to apply and is not very expensive.

Current Cost Accounting (CCA) Method: This method differs from General Purchasing Power Accounting and has now emerged as an important variant of the replacement cost. This method was first suggested in 1975 by the Sandilands Committee— an independent committee of inquiry into inflation accounting appointed by the Government of U.K. under the Chairmanship F.E.P. Sandilands, the then Chancellor of the Exchequer in the United Kingdom. Hard on the heels of Sandilands Committee Report (1975) came Exposure Draft (ED) – 18 issued by the Inflation Accounting Streering Group (IASG) also known as Morpeth. ED-18 required the companies to give inflation-adjusted accounts in the primary financial statements. However, due to some technical flows ED-18 was not well received. After considerable study and debate, in 1980, the Accounting Standard Committee in U.K. issued the standards on this subject i.e., "Statement of Standard Accounting Practice (SSAP) –16". Until 1985 SSAP-16 remained as the current accounting for price level changes (APC) standard despite many shortcoming leveled against it. Exposure Draft (ED) 35 was issued in 1985 as proposed successor to SSAP-16. The ED-35 (Accounting for the effect of changing price) will apply to all listed companies that are neither value-based nor wholly- owned subsidiaries.

The Current Cost Accounting may be defined as " a form a accounting where all assets are shown at current replacement value otherwise named as entry value and all liabilities are shown at present value". The main object of current cost accounting is to provide useful information that is available from historical cost based accounts alone, for
the guidance of the management and outsiders (Shareholders, Creditors, Potential Investors, Tax Authorities etc.) on certain important issues such as financial viability, return on investment, pricing policy, cost control and distribution decision and gearing. It seeks to judge the ability of the business to perform in the future as in the past and pays dividend or finances expansion without requiring new external financing.

Beside, this method is based on an economic theory of value and reflects a correct profit after matching current costs with current revenues and gives a correct valuation of assets and liabilities in the balance sheet at their current value.

Current cost accounting differentiates between operational gains and holding gains. Operating gains are defined as revenue less current cost of assets consumed. Holding gains are the gains that result from an increase in the value of physical assets owned by the firm. Holding gains should be retained in the firm so as to provide sufficient capital for maintaining the physical capacity of the business. Only operating profits are distributable profit.

The current cost accounting makes three main adjustments to trading profit calculated on historical cost basis before interest. These three adjustments are: depreciation adjustments, Cost Of Sales Adjustment (COSA) and Monetary Working Capital Adjustment (MWCA) besides gearing adjustment under which the current cost profit attributable to shareholder is obtained.

Cost of Sales Adjustment (COSA) represents the difference between the current cost of inventories at the date of sale and the amount charged as the cost of goods sold in computing historical cost profit.
The next item in the preparation of current income statement for the current financial year is the depreciation adjustment. This reflects the difference between depreciation calculated on current cost and depreciation already charged on the basis of historical cost income.

Another adjustment called as the monetary working capital adjustment (MWCA) reflects the amount of addition (or reduced) finance needed for monetary working capital as a result of changes in the input prices of goods and services used and financed by the business. Monetary working capital is the aggregate of (trade debtors + B/R + repayment + amount of the stock which has not been included in the cost of goods sold) minus (trade creditors + B/P + that part of the bank overdraft which is related with the stock). At the time of raising prices, a business needs more funds to finance monetary working capital. This adjustment reflects the additional need of funds.

The inflation accounting practice in foreign countries viz., United State of America, United Kingdom, Canada, France, Belgium, Sweden, Japan, Germany, Australia and Italy was made. The accounting for inflation has been in practice for quite some time of these countries during the last four decades there have been several proposals on how financial statements should be adjusted to show the effects of inflation. The earlier suggestions were to adjust the financial statements using general price index such as consumer price index. For example, in the U.K., SSAP-7 in 1974 and in the U.S.A. APB statement number 3 in 1969 and FASB statements in 1974 were suggested. These proposals were criticised because they did not indicate the effects or the changes specific to a particular enterprise. Price change for a given enterprise may vary
considerably more or less than the general price changes. The next move came from the
government sources and the suggestion was to move from historical cost to some form of
current value accounting based on the concept of revaluing physical assets such as
building, machinery and inventory in their value to the business. In the U.K. Sandiland’s
Committee 1975, in the U.S.A. Security Exchange Commission’s ASR-190 in 1976
suggested to revaluate the assets. However, the replacement of historical financial
statements by the full-scale current cost financial statements as primary statement was
first suggested in 1980 by the U.K.’s SSAP-16. The issuance of SSAP-16 is still
considered an important landmark in the history of British accountancy.

Recent proposals have abandoned the complete restatement approach in favour of
supplementary disclosure. The accounting profession in various countries had adopted
different experiments with different approaches and alternatives in apparent recognition
of the fact that there is theoretically no right answer and information provided by
different methods of accounting for changing prices may prove valuable to different
readers. These proposals are: in the U.S.A. SFAS-33 “Financial Reporting and Changing
Prices” issued in Sept. 1979 by the FASB. In Canada Section 4510 of 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 issued in July
1982 by the Australian 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. Thus, a most of the practices described above tend to reduce otherwise inflated profits resulting from changes in the price level, some might be considered sound, consistent, even standardised, others appear arbitrary and manipulative. But one fact is clearly evident, that these are not isolated example but practices that are being now adopted in a widespread manner. True these radical departure from our accounting standards are the results of multitude of influences.

The present position is that though there are very few countries which have officially adopted APC 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 APC standard to be perused. Obviously, there was never a consensus on any one method.

The study of inflation accounting practices adopted by some companies in India's corporate sector like Ashok Leyland Limited, Bharat Heavy Electricals Limited (BHEL), Carborundum Universal Limited and Voltas Limited. These companies used inflation accounting methods in preparation of their financial statements. The companies under study used the inflation-adjusted information up to 1974 (Ashok Leyland, Carborundum Universal Limited) while Bharat Heavy Electricals Limited used current cost accounting method up to 1984-85. These companies 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 were: practical difficulties in its implementation, non-acceptance of the final accounts for tax purposes, and difficulty in
understanding such accounts. The non-acceptance of inflation-adjusted accounts by the
tax authorities seemed to influence, implicitly or explicitly, the minds of most of the
executives. Although depreciation is an important factor influencing the accounting
results of a business enterprise during inflation, it is not adjusted for inflation even for
management accounting purposes. The methods of inventory valuation followed by
companies are of little help in countering the adverse impact of inflation on business
results. Inflation accounting by and large is done for management use only. The basic
objective 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.

Therefore, we shall now venture to offer some suggestions for consideration by
the Government, professional bodies industry 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.

Accounting for inflation has been under consideration for quite some time but the debate
still remains inconclusive. 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.

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.

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.

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.

* 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.

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

* The system of accounting for inflation should be so designed that the accounting measurement 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.

* 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.
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.

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.

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 short coming 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.