CHAPTER - IX

THE REVIEW OF LITERATURE

This chapter is in connection with the review of researches, research-papers pertaining of Inflation-Accounting. The review was made from the books on Inflation-Accounting, Journals and Theses on the topic. Review of Literature is helpful in determining the objectives of the study and is also helpful in designing the modus-operandi of the research.
Current Value Accounting was a subject of hot debate in 60s. It generally takes two forms: one, Replacement Cost Accounting (RCA); second, Realisable Value Accounting (RVA). A study made by Edward and Bell (1961) asserted that two components of income which are relevant to the analysis of the function of accounting are not identified in the conventional statement of accounting income. These components are: (a) Current operating income which results from operating activities and which may be calculated by matching current revenues with the current cost of resources exhausted in these activities. (b) Holding gains, which result from holding activities. These gains are also referred to as cost savings.

The Replacement Cost Accounting was evaluated afterwards. As regards the criterion of feasibility, Dickerson (1965) has shown that replacement cost accounting is not too time consuming and costly for practical implementation. Applying himself to the problem of converting data from historical cost to replacement cost for a small producer of moulded plastic articles, he reported that 95 hours of work were involved in
that translation, of which 40 hours were spent in familiarizing himself with the data. Criticism is also levelled against replacement cost accounting (RCA) on the basis that the measurements involved are subjective. In England, the Sandilands Committee recommended that the Government Statistical Service should publish as soon as possible a new series of price-indices specific to particular industries for capital expenditure on plant and machinery. Such a series of indices should be designed to provide 'standard reference basis' for making reasonable approximations of current replacement costs.

The derivation of replacement costs for inventories could present problems. However, when various different methods of valuing inventories used at present time are considered, it appears that replacement cost provides a more objective measure. Sterling (1970) also disfavoured replacement cost measurements by saying that RCA implies the substitution of specific asset's - value for money measurements, thereby abandoning a common unit of measurement.

The monetary gains and losses during inflation were also tackled through some studies. A study conducted by London Stock Brokers, Phillips and Drew
(Accountants' Weekly 31.10.1975) illustrated the massive size of monetary gains involved in reported corporate income under conditions of inflation, and the effects of alternative accounting methods. They took as their figures total United Kingdom corporate income for 1974 - excluding banks and oil companies - and worked out the following figures:

(a) Under HCA, total corporate income in 1974 amounted to £3.9 billion;
(b) Under C.C.A., total corporate income in 1974 would have been £1.6 billion, that is, 60% less than under historical cost accounting;
(c) Under C.C.A. plus the recognition of gains on monetary items as discussed above, which would have amounted to £1.7 billion, total corporate income in 1974 would have been £3.3 billion, that is, 15% less than under historical cost accounting.

The implications for companies, share-holders, investors, and the Government, of these figures need hardly be explained. They affect the size of reported income as regards retained income and dividends and the real burden of corporate taxation. Hence, because of the dangers of making accounting entries in respect
of gains or losses on monetary items, there is a case for showing them separately in supplementary statements rather than adding them to operating gains.

Wanless (1979) in a case study enumerated many points. His findings were:

i. The stated profit was increased by CPP accounting;

ii. The improper classification of monetary and non-monetary items will lead to illusory results;

iii. Increase in profit by using C.P.P. should not always be taken as a healthy sign.

Surveys carried out by the ICA and by the Sandilands Committee, established by the British Government to consider the problems of inflation accounting, revealed that many companies were departing from the historical cost principle, in their financial reports, though the revaluations of property were much more common than the revaluations of other fixed assets, whilst most companies were retaining the historical cost method of calculating depreciation. The Sandilands Report (1975) concluded that the piece meal way in which revaluations have been carried out has created considerable confusion and difficulty.
Few companies have revalued all their assets, few revalue their assets on a regular annual basis, and few disclose the exact basis of the revaluation. The result is that present day Balance-Sheets in that country consist of a mixture of entries of historic cost and valuations prepared on different bases.

It was in 1974 when the professional accounting bodies in United Kingdom recommended that a supplementary statement should be attached to the financial reports of companies showing the conversion of the figures in the financial reports in terms of their current Purchasing Power (C.P.P.) at the closing day of accounting period. They recommended that the Retail price-index (R.P.I.) should be used to effect the conversion of historic cost values into current purchasing power equivalents (S.S.A.P. 7, 1974).

The Sandilands Committee in its Report, called Sandilands Reports (1975), gave a summarised view of current Purchasing Power (C.P.P.) Accounting as follows:

"In summary, we do not think the concept of profit adopted by C.P.P. supplementary statements,
when appended to historic cost accounts, is useful to shareholders. It fails to show the company's 'operating profit', it is potentially misleading in including net gains on monetary items which exist only in terms of monetary units, and it shows how far the "Purchasing Power" of a shareholder's investment has been maintained in a sense which is not useful to him for any practical purpose. If C.P.P. does not provide useful information for shareholders, from whose point of view it is conceived, it is unlikely to provide useful information for other users of accounts."

The inflation Accounting should get the proper treatment to provide the special analyses of Management Accounting problem. Financial Accounting will also be giving sufficient amount of information if that is adjusted on the basis of price level changes (Gee, 1977, Scapens, 1977).

In Britain, the Report of Sandilands Committee (1975) and official Govt. Committee of Enquiry into Inflation Accounting came to the conclusion that inflation is not a phenomenon capable of objective measurement affecting all individuals and entities equally; and used this as an argument to justify the
complete rejection of the use of General indices in the system with the purpose that this system is based solely on specific price changes (Whittington, 1983).

Merret and Sykes (1974) produced an article which was very affluent in persuading the Govt. to introduce stock relief in 1974 as an emergency measure to prevent the taxation of stock appreciation the rise in monetary value of stocks held during a period.

Gupta, (1984) presented a survey of inflation accounting standard and their implementation status in U.S.A., U.K. and Canada. He noted that the recent proposal in Inflation Accounting has abandoned the complete re-statement approach in favour of supplementary disclosure. The status of Current Cost Accounting in many countries is fluid and confusing because there have been frequent issuances and withdrawals of CCA standards by the respective National Accounting Standard Setting Agencies. So, according to Gupta, Inflation Accounting remains a controversial topic and is likely to continue to be so in the near future.

De-Villiers (1989) studied the extent of discrepancy between accounting rate of return (ARR)
and internal rate of return (IRR) under inflation and specially how. It is influenced by assets' structure (i.e. the ratios of current depreciable and non-depreciable assets) employed by a firm. The author reviews the relevant literature, develops a theory to determine the extent of the discrepancy between ARR and IRR. Under inflation and presents the results of calculations to illustrate the patterns of the theoretical relationship derived by him.

In a case study, Dixit in 1984 studied the implementation part of inflation accounting system in a diversified manufacturing company (a disguised name). In the analysis of his observations he found that this company implemented the inflation accounting system by trial and error. It muddled through the various phases of implementation. As it learnt lessons from doing so, the gap between the conception and the effective implementation was that of four years. This cost the extra time and resources spent on the extended period of learning to the company. A well thought-out implementation plan could have avoided this loss. However, it did not give up the exercise even after the failure in the first attempt.

Based on the experience of this company, the process of implementing the inflation accounting system can be divided into the following four phases.
1. **Preparatory Phase:** Where the company chooses a method of accounting, it creates a data base and prepares itself to implement the system.

2. **Communication Phase:** Here the choice of the method and necessary guidelines are communicated to those responsible for implementing the system.

3. **Computation Phase:** The required computations are made.

4. **Consolidation and Publication Phase:** The accounts revised from the various units are consolidated.

He further suggested that if a multi-unit company plans to introduce inflation accounting then the corporate office will have to take the burden of the implementation of this accounting system.

Taffier & Tisshaw (1977) give an account of international accounting standard on accounting for changes in price.

Bsil Morre (1980) worked on inflation accounting in U.K. He selected the company engaged primarily in manufacturing and distribution for his study of inflation accounting. He observed that barring inter
year comparability of the measurement unit, the pattern of profitability was profoundly affected by the choice of accounting technique. He further found that the adjustment of increase in price-level or inflation would wipe out the apparent increase in normal profits. In his calculations he further observed that changing current cost depreciation and eliminating stock appreciation adjust only for the deleterious effects of inflation on profitability and ignore some of the possible gains.

Exposure Draft 35 (Accounting for the effects of changing price), the proposed successor to the SSAP 16 on current cost accounting became controversial. U.K. Standard on inflation-accounting has met with strong opposition from the Chartered Association of Certified Accountants (formerly known as the "Association of Certified Accountants"). The council of the Chartered Association has opposed the conversion of the exposure draft into a new standard on inflation accounting. In view of the Association, the efforts made to date to develop a widely acceptable accounting standard which overcomes the distortions in historical cost accounting caused by the changes in price-levels have failed primarily due to the fact that the attempt has always been made to impose a single solution on a multitude of different business circumstances. The Association, therefore, proposes that ED-35 and SSAP-16 should
be withdrawn in due course and replaced by a new standard which takes into account the diverse nature of business.

(The Accounting Magazine, Jan. 1985):

Dixit (1984) found that follow-up and scrutiny are an essential part of the implementation of the Inflation-Accounting procedure. In the absence of proper follow-up, the Units using such accounting-issues may relegate the exercise to the back-ground. The Monitoring is required till the system is put into operation.

The institute of C.A. of England and Wales, in 1969, has favoured the adjustment of changes in prices in the financial statements of the organisations (SSAP-7). Current purchasing power accounting or general purchasing power accounting has also been advocated by some experts in U.S.A. Some members of Inflation-Accounting Committee (1975) were of the view that the financial-statements should be prepared on current-cost (CC) basis only.

Some have favoured Replacement Cost Method (RCM). Use of a particular index is adopted for the
calculation of RPC for fixed assets as well as inventories consumed. In this case, the profit is calculated by subtracting the RC of assets used from the revenue. The Sandilands Committee is of the view that the realistic measure of profit of a firm was the amount it could distribute to Shareholders and still be capable of regenerating its existing fund of operations at current prices (Mc-Cost & Vencil, 1976).

An Exposure Draft-18 was published in December 1976, in U.K. on the recommendations of S.C. which was widely accepted by the U.K. govt. It recommended CCA for price level changes adjustments.

Goyal et al (1985) in their article on 'Inflation Accounting Approach to the Management of Cash' observed that the historic and the restated figures yield quite different results. Be it cash management, or the inventory management or management of receivables, if studied without making proper adjustment for inflation, would provide a misleading picture as conventional studies do. They suggested that studies be made in the right perspective.

Kertz (1978) and Norton et al (1979) examined general price level accounting and Mausals (1983) tested current cost accounting (CCA). In these studies,
generally inflation accounting was not found to be superior to historical cost accounting. Skogsvik (1990) extended these studies by testing CCA ratios as predictors of business failure. Many previous studies like Blum (1979) and Zaugren (1985) have found HCA to be a good predictor of business failures. In his study, using Swedish data, Skogsvik attempts to provide some additional evidence about the incremental information content and predictive ability of CCA data. Like-Mensah (1983), a firm-specific application of CCA, in the sense of Edwards and Bell (1961), is tested by him. He used profit analysis and estimated prediction models for 1 year to 6 years before failure. He noticed that the predictive performance of the CCA ratios has been similar to that of the HCA ratios. However, as theory might have led one to expect, he noted, that the CCA ratios performed well when the inflation rate was high as compared to the period when inflation rate was not so high.

The discussion on the inflation-Accounting has not considered how any of the various proposals would have fared if applied to the small company sector. On grounds of cost and verifiability, both the accounting profession and businessmen seem to have set aside this issue. As a result there appears to be a lack of empirical research on the usefulness of CCA as compared to
HCA for users of small company-accounts, with one exception of Keasay and Watson (1986) who examined the comparable merits of the two accounting frameworks in the prediction of small company failures. The period of analysis chosen was one when inflation was substantial, which necessitated relatively larger CCA adjustment, and would therefore have been expected to generate positive results. Predictions of company performance were developed by using multiple discriminant analysis (MDA). The convenience matrices were checked for quality and linear discriminant function was used where the dependent variable was failure or non-failure and the independent variables were the financial ratios. Ratios pertinent to the peculiar characteristics of the small company sector were selected. However, unlike Skogsvik, the results indicated that the HCA and CCA data sets were almost perfect substitutes. Taken together, the studies provide some weak support, at best, for the proposition that CCA disclosures bring about improved predictions of corporate failure.

A number of studies in the United Kingdom and the USA have been made regarding the relevance of accounting data as a predictor of corporate takeovers or attempts. Hasbrouck (1986); Palepu (1986); and Bartley and
Boardman (1986) are some examples of that. Most of the studies were intended to develop classificatory models to be used as investment tools in order to obtain a better understanding of the motivations of takeovers. Among these studies, Bartley and Boardman (1986) provide direct comparison of inflation adjusted data and HC data in the context of corporate takeovers. They found that replacing the HC valuation ratio with an inflation adjusted valuation ratio increased the classificatory accuracy of MDA models. In their later study, Bartley and Boardman (1990) attempted to determine whether current cost (CC) and constant dollar (CD) financial data in conjunction with Historical Cost (HC) have the potential to improve the predictive ability of models that classify companies as take over targets. They used MDA models, instead of using a matched-pair design as other studies have done. They opted for an unmatched sample with the ratio of targets to non-targets closely corresponding to that of the population. The authors justify their choice of the design by contending that the greater cost of gathering data for an unmatched sample is a primary reason why matched pair designs are used more often. The results indicated that the models combining CC and CD data with HC data were more accurate than simple HC models. The
results suggest that CCA data can enhance the prediction of mergers and takeovers.

Thomson and Walson (1989) found in their study that there was empirical evidence that the level of earnings affect the level of dividends. They examined whether these earnings are HC-earnings or CC-earnings, and to what extent it is possible to discriminate between them. They used the method of estimating the models on cross-sectional data. Instead of using the two-stage methodology used by Beaver et al (1982), they used the current cost adjustment and introduced them into the equations together with the profit variable. They found that the profit after interest proved to have the closest relationship to dividends. They observed that HC profits provide the best explanation for the change in dividends. The authors did not find any convincing evidence to suggest that any of the individual CC adjustments plays a significant part in the dividend decision.

Dharan in 1988 also obtained the same results as given above by Thomson and Wasson. He examined three years of current cost data for 325 United States firms and reported that changes in HC earnings rather than current cost earnings explain the frequency
of dividend changes. He noticed that dividend growth rates are explained by HC earnings' changes and not by CC earnings' changes. Further, he saw that a regression of percentage change in HC and CC earnings indicated that the co-efficient for HC earnings was positive and significant while the co-efficient for CC earnings was non-significant.

Revaluation of assets and share price-revisions are the issues which have been examined by many researchers. A few among them, Beaver et al (1982), Schafer (1984) and Ohlsen (1985) did not find any additional explanatory power of CCA on share price returns. However, Bublity et al (1985) and Peasnell et al (1987) did find a significant additional effect.

Emanuel (1989) has explored the issue in the context of 143 material asset revaluations made voluntarily over the period 1968-79 by New-Zealand companies. He used the market-model for most of the testing procedures with calculated Beta using the Scholes and Williams (1979) estimating procedure and the liabilities in accounts and advocated it for a sound managerial decision-making procedure for the making and evaluation of investment decisions. On the issue of performance assessment, he has compared
the performance of CC/CD data. He has pointed out that the HCA information does not generally yield data that are as much comparable as much the CA data are in this respect. He illustrated this point with the case of a major US airline(X) which had much lower HC rate of return in recent years than its close competitor (Y). He noted that because of a considerably better realisable Real Cost Savings of record carrier X's total or comprehensive current Real Income rate of return had consistently exceeded that of carrier Y. He observed that it was due to the aeroplanes owned by carrier X than those by Y. By extending the issue of comparability, the author advocated that the measurement problem with HCA involves two possible manipulation problems. Measurement manipulation and events manipulation, and to CC/CD accounting only the former is applicable in a narrowly restricted sense. He also opined that inflation might also affect performance comparisons among firms with in a single year. In inflationary periods, the firm earns a larger portion of the income through operations based on currently prevailing prices.

Bell (1986) has enumerated the need for evaluating investment decisions in terms of current values for the Banking Sector. He has used the illustration of banks and savings institutions in the
United States, which experienced over valuation of assets and liabilities without reporting the same in the accounts, as everything was fixed in nominal value terms. On deregulation of the banking sector, the interest rate differential on interest received and paid turned sharply adverse. Under these circumstances knowledge of current values would have emphasized a need for intermediate-decisions which was marked by HCA procedures.

Throughout the last century, the debate on the relevance of different valuation measures has continued. The solution probably changes according to the decision area. With the comparatively reduced pressure of inflation, inflation adjusted accounting loses its practical significance. However, in their recent study, Hallworth et al (1987), have indicated that there is a need to reconsider the increasingly popular belief that inflation is no longer high enough to bother with current cost disclosures, as the effects of past high inflation persist long after inflation has abated.

Objectives of the study:

After reviewing the literature on inflation Accounting, it was concluded that this accounting method is in infantile state. To develop this method
practically, it required the research and development programmes. Keeping this idea in mind, the following objectives have been taken in the present study:

i. To find out the knowledge of Accountants, Executives, Auditors and Academicians about the inflation accounting.

ii. To find out the most important financial activities and items influenced by the inflation.

iii. To know the constraints in the way of adjustment of price level changes.

iv. To know the views of concerned parties regarding the use of indices to change the monetary items of the financial statements.

v. To find out the reasons of disinterest of the Accountants and Executives of using the inflation accounting.

vi. To know whether C.P.P. or CCA is more useful.

vii. To suggest certain points to develop "Inflation Accounting" in India.