CHAPTER THIRD

MONEY, PRICES AND ACCOUNTING
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Accounting for changes in price levels is concerned with the preparation of accounts which make some allowance for changes in the purchasing power of money. In accounting for price level changes main consideration is given to term 'price level' and a number of closely associated terms like value of money, general purchasing power of money etc. In the present chapter a detailed study of these terms will be made alongwith a commentary on their role in 'accounting for price level changes'.

MONEY

Money is the pivot round which whole of the economic science clusters. In modern times for every business activity money is required. Now a days all the business accounts and books record the transactions in terms of money value. The definitions of money given by various authors are as under:

(1) 'Money is a kind of claim upon all other members of the community, a short of order or promise to deliver which can be enforced whenever the owner pleases. It is a means to an end not for its own sake but as a means of obtaining other articles or of commanding the services of others'.

(2) 'Money is simply purchasing power – something which buys things – it is anything which is habitually and widely used as a means of payment and is generally acceptable in the settlement of debts'\(^1\) – G.D.H. Cole.

(3) 'Money is anything which is commonly used and generally accepted as a medium of exchange or as standard of value'\(^2\) – Kent.

(4) 'The word money has been used to designate the medium of exchange as well as the standard of value'\(^3\) – Halm.

From the above definitions it is clear that any unit which acts as medium of exchange and standard of value and is generally accepted in payments, is called money.

**DEFINITION OF MONEY FROM ACCOUNTING POINT OF VIEW**

The definition of money considering the effects of changing price levels has been given by The Institute of Cost and Works Accountants, London. This definition is as under:

'Money consists of –

(a) Media of exchange which passing freely from one person to another transfers the command of stated amounts of general purchasing power. These are:

(i) Coins issued by competent authority and undefaced.

(ii) Notes issued by competent authority viz. governments, bank of issue.

(b) Bankers' deposits or the liabilities of banks to their customers — command over which is transferred from one person to another by means of, for example:

(i) Bill of exchange,
(ii) Promissory notes,
(iii) Letters of credit.

(c) Unused overdraft, which is the difference between the total amount authorised to be withdrawn by borrowers and the amount actually overdrawn. The amount overdrawn is represented by media of exchange in circulation\(^1\).

FUNCTIONS OF MONEY

Money discharges the following functions:

(A) Fundamental Functions

Following are the fundamental functions of money which were performed by it in every stage of economic development.

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(i) **Medium of Exchange**

With the help of money the other commodity in exchange of one commodity can be easily obtained because the later can be sold in the market and thereafter the former can be purchased. As money acts as a medium of exchange payments can be made as soon as a bargain has struck.

(ii) **Standard of Value**

Money is the common indicator of prices because in the terms of money the prices of each and every commodity are expressed. Money measures the value of commodities and services and establishes an exchange ratio between commodities and services.

(B) **Secondary Functions**

The secondary functions of money are also called derived functions because they are mainly based on primary. The secondary functions of money can be expressed as under:

(i) **Standard for Deferred Payments**

There are various payments which are not redeemed immediately but are postponed for future. In modern times various business activities are based on credit. The chief characteristic of money is that it is also a standard for deferred payments because of the following reasons:

(a) Comparatively money values are more consistent than the value of any other commodity.
(b) Money possesses the characteristic of general acceptability.

(c) In comparison to other commodities money is more stable.

(ii) **The Store of Purchasing Power**

The purpose of obtaining money is that commodities and services may be purchased but it is not essential that money may be spent as soon as it has been received. It may be accumulated for some time and may be spent after a certain period of time in future. Hence purchasing power can be easily stored in terms of money. This leads to capital formation and accumulation.

(iii) **Transfer of Value**

Nowadays business has crossed the national boundaries and it has become national as well as international. Due to feature of general acceptability of money, purchasing power can be easily transferred from one place to another.

(C) **Contingent Functions**

Following are some contingent functions which are performed by money in advanced countries:

(i) To distribute social income.

(ii) To equalise marginal utility and marginal productivity.
(iii) To help in credit expansion.
(iv) To provide liquidity to capital.
(v) To act as guarantor of solvency.
(vi) To provide liquidity to assets.
(vii) To act as bearer of option.

Generally about the functions of money following proverb is prevalent -

'Money is a matter of functions four,
A medium, a measure, a standard, a store'.

ROLE OF MONEY IN MODERN ECONOMY

Following points clear the role which money plays in modern economy:

(1) **Improvement and Convenience in Exchange**

Due to origin of money the difficulties of barter system could be eliminated and there may be an improvement in exchange system. The credit of international exchange relations goes to money.

(2) **Development of Credit System**

Money is the basis of deferred payments. It has contributed in the origin and development of credit institution and business activities.
(3) Division of Labour and Specialisation

Modern economic life is founded on specialisation and division of labour and money has made it possible. Money has contributed to the development of specialisation and division of labour by making exchange an easy and simple process and by making joint production possible.

(4) Economic Development

Due to money capital formation and accumulation of capital could be possible. Money has made all round development of economics and provided mobility to capital.

(5) Consumer's Sovereignty

As money is generally acceptable and acts as a bearer of option, the consumer can utilise his resources to his maximum satisfaction.

(6) Measurement of Economic Welfare

In the absence of money it was not possible to measure economic welfare and to make a comparative study of it. Money has provided economic welfare a precision and a statutory form.

(7) Operation of Capitalistic Economy

The measurement of cost of production, pricing of products, determination of profitability and financial position etc. is all possible only in a monetary economy. Hence money
helps in the operation of complex capitalistic economy.

(8) **Mobility of Economic Resources**

Owing to facility of money investments can be shifted from uneconomic ventures to economic ventures. Actually money has provided mobility to capital and other resources.

(9) **Just System of Distribution**

Money helps in just and equitable distribution of income. In the form of money the productivity of each factor of production can be correctly measured and it can be rewarded accordingly.

(10) **National Unity**

In all sectors and groups one unit is generally accepted as money. This gives proper enunciation to national unit. General acceptability of money is also indicator of the fact that all groups of society accept general rule and administration.

(11) **Index of Progress**

The progress of any society is also judged with the help of money. Today that society is said to be advanced and progressive whose monetary system is advanced and well organised.
(12) **Political Awareness**

Money has induced political awareness among the public. Due to introduction of money activities of state have increased for the completion of which various types of taxes have been introduced like income tax, sales tax, excise duty etc.

**VALUE OF MONEY**

As money acts as medium of exchange, standard of value etc. it is widely used in business and daily life for purchasing and selling commodities and services. As other commodities and services have value, money also possesses value. The value of every commodity is its exchange power. In the same way value of money is also its purchasing power. The quantity of commodities and services which can be purchased from money is the purchasing power of money. In simple words we can say that the value of money is the purchasing power of money, the ability of each unit to command goods and services in exchange. When a unit of money is in a position to purchase more goods and services, the purchasing power of money increases and vice versa. When the prices of commodities increase, the value of money declines but when the prices of commodities and services go down, the value of money increases.

**DIFFERENT MEANINGS OF VALUE OF MONEY**

The term value of money is used in different senses. These are as under:
(i) External value of money i.e. exchange rate.
(ii) Value of money for obtaining it as loan i.e. interest rate.
(iii) Metallic value of money.

Generally value of money is used in terms of its purchasing power. In itself money has no value and is not in a position to give any satisfaction. Money is only a medium and a medium of obtaining commodities and services. Hence the real and proper meaning of value of money is its purchasing power.

FACTORS CAUSING VARIATIONS IN THE VALUE OF MONEY

The value of money is determined by the relative forces of demand and supply. The demand of money is derived and is not direct and its supply consists of legal money as well as optional money. Value of money is affected to a great extent by the following factors:

(1) **Demand for Money**

There is a demand for money from various groups of the society like consumers, businessmen, agriculturists etc. Actually demand for money is the total of all commodities, services and property rights exchanged for money in the course of a given period of time.

(2) **Supply of Money**

Supply of money affects the value of money. In
supply of money all those articles are included which are used as medium of exchange for commodities and services.

(3) **Velocity of Money**

The supply of money does not depend on the total amount of money available but equally upon the velocity at which it changes hands. Hence it can be said that velocity of money also affects the value of money. As far as velocity of money is concerned, it is affected by the following factors:

(i) **Quantity of Money**

The velocity of money will be lower if the quantity of money is more than its demand.

(ii) **Propensity to Consume**

There will be more velocity of money if propensity of consumption is higher among consumers.

(iii) **Prevalence of Cash Transactions**

If most of the transactions are settled through payment in cash, the velocity of money is higher.

(iv) **Duration of Credit Transactions**

The velocity of money is higher if credit period is short.

(v) **Liquidity Preference**

If there is more liquidity preference among the
public, the velocity of money is lesser but the lesser liquidity preference results in higher velocity of money.

(vi) **Facilities of Borrowing**

If in any country there are more facilities of borrowing, the number of credit transactions increases and the velocity of money decreases.

(vii) **Increase in Prices**

With an expectation of increase in prices there is an increase in business activities and the velocity of money increases.

(viii) **Period of Wage Payment**

If the wages are paid weekly or fortnightly the velocity of money is higher as compared to the situation where wages are paid monthly, six monthly or annually.

(ix) **Development of Transport and Communication**

Due to development of transport and communication velocity of money increases because there is an increase in business transactions.

(x) **Economic Development**

The velocity of money is affected to a great extent by the degrees of economic development. The velocity of money is higher in developed economies.
MEASUREMENT OF VALUE OF MONEY

Accounting records various transactions in terms of monetary value. There are various factors due to which the value of money changes. As our historical accounting system is not in a position to depict the effects of changing price levels, the accounts do not show true and fair position of the business. For accounting for changes in price levels it is essential that the up to date information should be available with the accountant regarding changes in price levels. The changes in price levels can not be ascertained until we have information about changes in value of money. Hence it is essential that value of money should be measured. For the purpose of measurement of value of money index numbers are constructed.

PRICE INDEX NUMBER

Most of the advocates of price level accounting accept that use of one or more price index numbers is essential if traditional accounting system is to be adjusted under inflationary conditions. It is, therefore, highly desirable that accountants should have knowledge about construction and use of index numbers. There are different types of index numbers and the accountant will have to decide whether the index number used for adjustment purposes should relate to prices generally or prices of specific assets.
DEFINITIONS OF INDEX NUMBER

An index number expresses the changes in the purchasing power of money and facilitates in preparation of accounts incorporating the effects of changes in price levels. Following definitions indicate the meaning of index numbers clearly:

(1) 'An index number of prices is a figure showing the height of average prices at one time relative to their height at some other time that is taken as the base period.'\(^1\) — Lester Chandler.

(2) 'An economically relevant definition of index number can not be independent of purpose in mind and for each purpose a separate index must be computed.'\(^2\) — Heberler.

(3) 'Index numbers are series of numbers which show variations in price levels with those in the value of money. These are relative numbers which enable us to compare the purchasing power of money at different periods of time and measure the movements.'\(^3\) — Secrist.

1. Lester V. Chandler: An Introduction to Monetary Theory, Page 10.
"An index is a series of measurements, expressed as percentages, of a relationship between the average price of a group of goods and services at a succession of dates and the average price of a similar group of goods and services."¹ - AICPA.

CONSTRUCTION OF INDEX NUMBERS

Index numbers are the sign and guide posts along the business highway that indicate to the businessman how he should drive or manage his affairs. There are a number of problems which arise during construction of index number. These problems are as under:

(1) **Purpose of Index Number**

The determination of object is the first stage in the construction of index number. In order to ascertain changes in price level separate index number should be prepared for each separate purpose.

(2) **Selection of Commodities**

Price indices are prepared on the basis of prices of commodities because there is a change in the prices of commodities. Now the problem is which commodities should be

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¹ Reporting the Financial Effects of Price Level Changes, American Institute of Certified Public Accountants, (1963), Page 63.
taken while preparing index number and what should be their type. In this respect it is worth noting that the commodities included in the index should possess the following qualities:

(i) Commodities should be representative.
(ii) Commodities should be such as may be recognised easily.
(iii) Commodities should be of same type in quality, standard etc.
(iv) Commodities should be popular.

(3) **Number of Commodities**

Next problem is how many commodities should be included in index number. The number of commodities to be included in the index depends upon the following factors:

(i) Time available.
(ii) Money.
(iii) Predetermined level of accuracy.
(iv) Other circumstances.

(4) **Classification of Commodities**

If there are a number of commodities to be included in index number, these should be suitably classified. For example in India, in economic adviser's wholesale index number 112 commodities have been classified in 5 main groups and 20 sub-groups.
(5) **Selection of Prices**

Information about prices of commodities is essential otherwise construction of index number would become impossible. Volume of changes in price level is determined on the basis of prices of commodities. Hence while selecting the prices of commodities following factors must be kept in mind:

(i) Type of prices whether wholesale or retail.
(ii) Form of expression of prices whether money price or quantity price or inverse price.
(iii) Place for obtaining prices.
(iv) Sources for obtaining prices whether official or non-official etc.

(6) **Selection of Base Year**

The most important work in the construction of index number is the selection of base year. The base year should be normal from every point of view i.e. the years of drought, flood, economic crisis etc. should not be taken as base year. The following two methods are prevalent for the selection of base year:

(i) Fixed Base Method:
   (a) One year base or
   (b) Multiple year base in the form of average.

(ii) Chain Base Method.
(7) **Selection of Average**

Calculation of average of relatives taken under either fixed base or chain base method is an important task in the construction of index number. Now the problem is which average should be used whether simple average, weighted average, median or geometric mean. Normally simple average is used but different averages may be used according to necessity. For example if there is greater variation in relative prices geometric mean should be used.

(8) **System of Weighting**

While preparing index number due weightage has to be given to each commodity according to its importance. Although equal weightage may be given to each commodity but in the practical life it is not so. The selection of proper weights is an important problem. If there is a slight carelessness in the selection of weights, the results may be confusing. Generally weights are determined either on the basis of quantity or on the basis of value. The indices in whose construction no weights are provided are called simple or unweighted index numbers and the indices in whose construction weights are provided are called weighted index number.

(9) **Frequency and Promptness of Publication**

For an account one of the most important characteristic of a price index is its frequency and promptness of publication. Some of the indices may be admirable from content
point of view but they may not be useful for the accountant because they are published either yearly or half yearly. Hence for the preparation of price level adjusted index numbers, it is essential that they should be published frequently after short intervals.

VARIous TYPES OF INDICES FOR ACCOUNTING ADJUSTMENTS

The vast majority of advocates of accounting for price level changes accept that the use of one or more index numbers is essential for making adjustments unconventional financial statements during periods of price level changes. But there is a controversy which type of index number should be used for this purpose. The different types of index numbers that can be used by the accountant for adjustment purposes during a period of price level changes are as under:

(I) General Price Level Index

This index number is concerned with the overall effects of inflation on all the goods and services that are sold in a particular country. They cover spending by the personal, business and public authority sectors. Actually business capital taking all additions and withdrawals into account is considered to have been maintained if it has increased by the same proportion as goods and services included in the index. There is a problem of frequency and speed of production in case of general price indices.
As far as accounting adjustments with the help of general index are concerned, there are a number of objections which are based on the point of view that neither the shareholder nor the business organisation is concerned with all the goods and services available in a particular country. Both the groups are normally concerned with a rather restricted range of goods and services and so a more specialised index will be more appropriate.

However, if it is desired that the accounts should reflect the overall effects of price level changes on all the goods and services that are sold, the general index may be used for making necessary adjustments in historical accounts during a period of price level changes.

(II) Business Investor Index

This index is related to the costs incurred by the typical business investor. Supporters of business investor index suggest that capital will only be maintained if the ability of the shareholder or business proprietor to purchase consumer goods is held constant. The major criticism in use of the business investor index is that the shareholder or business proprietor may not intend to use the money invested in a business for eventual consumer goods or services.

(III) Company Purchasing Power Index

This index is related to the purchasing power of
the business organisation. Attention is concentrated on the assets side of the business balance sheet and capital is regarded as a collection of physical assets, the real value of which must be held constant for capital to be maintained. Actually this type of index includes all those assets in which business organisations generally invest. One of the major advocates of this viewpoint has been Mr. E.S. Hendriksen\(^1\) who has suggested that investment purchasing power can be related to individual firms, sectors of industry or industry as a whole. His own preference will be for one general investment purchasing power index which will presumably include all those assets in which business organisations invest. In most countries there is at present time great difficulty in finding suitable price indices for representing these viewpoints.

(IV) **Business Asset Indices**

Under this approach several index numbers are used based on the changes that have taken place in the costs of individual operating assets. In this approach the use of index numbers is not essential as long as similar assets are available in the market e.g. current replacement cost of stock items can be easily ascertained with the help of catalogues and price lists. The absence of identical or similar asset in

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the market creates same difficulty and its value can be ascertained by the use of index numbers.

**CHOOSING AN APPROPRIATE INDEX**

The choice about the use of a particular type of index will depend upon the fact that for which group accounting information is required because affairs of a business organisation can be looked at from many different points of view. The management accountant usually tends to examine matters from business organisation's angle and he therefore has a natural preference for a system which attempts to show the current value of the business assets and in this case the use of one or more specific asset price indices is of considerable assistance. On the other hand the practising accountants to be on 'the outside looking in' because many of his responsibilities are tied up with the interests of shareholders and other external parties. Hence practising accountants prefer to adjust financial statements with a general price index which is related to the spending habits of investors or consumers as a whole. Hence while preparing price level adjusted accounts choice about an appropriate index number has to be made. Here we shall make a comparative study of the arguments for and against the use of one general index or several specific indices.

**Use of One General Index**

There are two schools of opinion regarding use of
index numbers for preparation of price level adjusted account. One school of opinion favours the use of one general purchasing power index whereas another school of opinion is in favour of using various specific indices. The proponents of one general purchasing power index put the following arguments in support of their approach:

(1) **Scale Adjustment**

General price index replaces the monetary unit of measurement which ceases to be stable during the changing price levels. Due to this financial statements presented at one time are comparable in terms of purchasing power.

(2) **Uniform Measuring Rod**

As general purchasing power index provides a uniform measuring rod, it should be used for accounting for changing value of money.

(3) **A Tool for Comparison**

Individuals and enterprises often wish to compare collection of resources but comparison is complicated because money is used as the standard of comparison whose purchasing power is fickle. The general purchasing power index may be used as a standard to compare diverse resources because due to this the defect of money as the standard will be overcome.

(4) **Maintenance of General Purchasing Power of Shareholders' Capital.**

According to the proponents of general index
assets as well as shareholders' capital should be restated through general index because profits will emerge only after the general purchasing power of the shareholders' capital has been maintained.

(5) **Accounting for Stewardship**

The use of a general purchasing power index is also advocated for presenting information to the proprietors showing how their funds have been utilised and the profits derived from such use.

**Use of Several Specific Indices**

The critics of general purchasing power index do not agree with the use of one general index for preparation of price level adjusted accounts. They advocate that several specific indices should be constructed and used for different purposes. The supporters of the viewpoint of use of several specific indices put the following arguments in support of their viewpoint:

(1) **Uncertain Concept**

The concept of general purchasing power is very uncertain and ambiguous. That is why it can not be used in the field of accounting. To any one problem the general index can not be used with reasonable amount of accuracy. On the hand the specific indices can be applied to individuals and entities accurately.
(2) **Less Open to Criticism**

Special indices are less open to criticism because they are less ambitious in aim and simpler in structure.

ONE GENERAL INDEX VS. SEVERAL SPECIFIC INDICES – A CONCLUSION

The index controversy is certainly a very complicated issue in the field of price level accounting. The ideal solution is that both general and specific index numbers should be used in an inflation accounting system. If this is done the calculations will be made with more precision.

EFFECTS OF USING GENERAL AND SPECIFIC INDEX NUMBERS

Now an examination of the effects of using general and specific index numbers for preparation of price level adjusted profit and loss account and balance sheet will be made. For this purpose following two examples are being taken:

Example No. 1

XY Ltd. purchased goods on 1st July 1980 for Rs.1,000. These goods were sold on 31st December 1980 for Rs.1,700. During this period there is a general increase in prices of 8% and an increase of 10% has occurred in the prices of similar goods. On 31st December 1980 an identical quantity of replacement goods has been purchased. Show what profit
XY Ltd. has made on this transaction?

Solution

(1) Use of Specific Index Method

The conventional accounting methods will produce a gross profit figure of Rs.700 viz. (Rs.1,700 - Rs.1,000). As the continuing business has to replace the goods sold, the supporters of specific index method would suggest a profit of Rs.600 i.e. (Rs.1,700 - Rs.1,100). They do so because an equivalent amount of replacement goods will cost Rs.1,100. As conventional accounts show a profit figure of Rs.700, there is a fear that company may distribute an amount above Rs.600 and may be put in a critical situation for replacement of identical quantity of goods. Hence distribution of an amount above Rs.600 will be damaging to the company. This view point is expressed in the following two balance sheets prepared after the purchase of original goods and replacement goods respectively:

**BALANCE SHEETS**

( Specific Index Method )

<table>
<thead>
<tr>
<th></th>
<th>After the purchase of original goods</th>
<th>After the purchase of replacement goods</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock of Goods</td>
<td>1,000</td>
<td>1,100</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,000</td>
<td>1,700</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Assets Revaluation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Profit</td>
<td>-</td>
<td>600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,000</strong></td>
<td><strong>1,700</strong></td>
</tr>
</tbody>
</table>

(ii) Use of General Index Method

If general index method is used for preparing price level adjusted accounts the profit figure will come to Rs.620 i.e. (Rs.1,700 - Rs.1,080). The supporter of general index method argue that the business investor will require Rs.1,080 on 31st December 1980 for being as well off in purchasing power terms as he was with Rs.1,000 on 1st July. The Rs.80 increase in capital will be shown as capital maintenance reserve. In such case the Balance Sheets (i) after the purchase of original goods and (ii) after the purchase of replacement goods will appear as under.
BALANCE SHEETS
(General Index Method)

<table>
<thead>
<tr>
<th></th>
<th>After the purchase of original goods</th>
<th>After the purchase of replacement goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Rs.</td>
<td>Rs.</td>
</tr>
<tr>
<td>Stock of Goods</td>
<td>1,000</td>
<td>1,100</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>600</td>
</tr>
<tr>
<td></td>
<td>1,000</td>
<td>1,700</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Capital Maintenance</td>
<td>-</td>
<td>80</td>
</tr>
<tr>
<td>Reserve Profit</td>
<td>-</td>
<td>620</td>
</tr>
<tr>
<td>Profit</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,000</td>
<td>1,700</td>
</tr>
</tbody>
</table>

Conclusions

(1) According to specific index method profit comes to Rs.600 whereas as per general index method profit figure comes to Rs.620.

(2) As per specific index method asset revaluation reserve of Rs.100 is not available for distribution.
and the profit figure can be matched with cash available. But when we apply general index method we find that distributable profits are Rs.620 because supporters of general index method say that stock holding profit is distributable because it represents a gain arising due to changes in price level.

Thus we can say that conventional profit figure of Rs.700 includes the following:

(i) Operating profit,
(ii) Stock holding profit, and
(iii) Fictitious inflationary profit.

Example No. 2

Mahendra Ltd. purchased land for Rs.50,000 and buildings for Rs.1,00,000 on 1st January 1979. By the end of the calendar year, general prices have increased by 15 per cent, land prices by 10% and buildings by 20 per cent. What figures should be shown at assets side of the Balance Sheet on 31st December? Assume that depreciation is to be ignored.

Solution

As per different systems, different figures will be shown in the Balance Sheet arrived at as under:

(1) **Conventional Accounting System**

Under conventional accounting system land and
buildings will be shown at historical cost i.e. the cost at which these were acquired i.e. land at Rs.50,000 and buildings at Rs.1,00,000.

(2) **Specific Index Method**

If price level adjusted accounts are prepared and specific indices are used land will be shown at Rs.55,000 i.e. Rs.50,000 + 10% for increase in prices and buildings at Rs.1,20,000 i.e. Rs.1,00,000 + 20% for increase in prices.

(3) **General Index Method**

If one general index is used for preparing price level adjusted accounts under inflation accounting system land will be shown in the Balance Sheet at Rs.57,500 i.e. Rs.50,000 + 15% for general increase in prices and buildings at Rs.1,15,000 i.e. Rs.1,00,000 + 15% for general increase in prices.

**Conclusions**

From the study of above example it is clear that use of general and specific indices produce very different results. Following points are worth noting:

(i) The use of general index for asset adjustment purposes shows all long term assets in the end of year purchasing power terms.

(ii) The use of specific indices for asset adjustment shows assets at current replacement costs.
SUMMARY

Money discharges three chief functions by acting as a medium of exchange by means of which payments can be made as soon as a bargain has been struck, a standard of value which evaluates all commodities other than money and a store of value which provides a stock of readily available purchasing power. The particular function of money which is important for accounting purposes is that of acting as a standard of value. For acting as a standard of value it is essential that value of money should be maintained in order to ensure that the purchasing power of money may remain constant over an extended period of time and that the parties involved in a long term settlement of obligations may not suffer loss by reason only of the passage of time. Due to price level changes this desirable stability of value of money has not, in fact, been maintained because the purchasing power of money has diminished and cost of living has increased. For the purpose of measuring the value of money during a period of price level changes indices should be prepared because they give an indication of general purchasing power of money e.g. indices of wholesale prices give an indication of the purchasing power of producers' money and indices of retail prices e.g. cost of living indices give an indication of the general purchasing power of consumers' money.
As value of money and its purchasing power is variable and not stable it becomes essential that the accounts should incorporate the due adjustments for changes in price levels so that they may reflect a truer and fairer view of the business. Hence accountants will have to make necessary adjustments in conventional accounts for changes in the purchasing power of money with a view to bring precision and accuracy in accounting information. In this process the accountant will have to convert historical costs into current values. The following methods are suggested for converting the historical costs into current values:

(i) Average wholesale price indices for all commodities.
(ii) Appropriate component of wholesale price indices.
(iii) Consumers' cost of living index.
(iv) Insurance values.
(v) Real estate tax assessment.
(vi) Appraisal values.
(vii) Values as assessed for wealth tax.
(viii) National Income Deflator.
(ix) Any other appropriate combination or method specifically applicable to the organisation.

As far as use of indices for making adjustments in historical accounts for incorporating the effects of price level changes is concerned some accountants suggest that general index numbers should be used while others suggest
that several specific index numbers should be used for adjusting different items. On the other hand some accountants have suggested that both general and special indices should be used for making necessary adjustments. In such case they suggest that capital value should be adjusted with the help of a general price index and other long term assets and stock should be adjusted with the help of one or more specific price indices.\(^1\) The effect of such adjustment will be that the balance sheet will show information about maintenance of shareholders' funds and also the current values of the assets. So it is difficult to arrive at a common system of index numbers applicable to all enterprises in the country at one point of time. While making choice about use of index numbers the main thing to be considered is that the accounting figures produced by it should represent fair and reasonably correct models of the operations of enterprise. Also the price index number proposed to be used should be such that is made available at monthly intervals with very little delay in production.

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1. 'Accounting Under Inflationary Conditions' by Patrick R.A. Kirkman.