Chapter - 4
VARIOUS COMMITTEE REPORTS AND RECOMMENDATIONS ON
INFLATION ACCOUNTING.

Comparative study of Inflation Accounting, Overseas:

After having discussed the various methods of Inflation Accounting and price level adjustment thereon, it would be relevant to look into the comparative position of the present status of the same in various countries. The following discussion would throw light on the matter.

We may note, "that rightly or wrongly, some version of current cost accounting (CCA) is favoured in a majority of the various pronouncements, and that the main differences between the various CCA models tend to be confined to the ways in which gains and losses on holding loan capital are treated." ¹

Another common feature suggested in almost each country which submits to inflation accounting method is to require only supplementary information on the technique adopted retaining historic cost basis of accounting as the basic accounts. The only exception is the SSAP-16 in the U.K. which provides that CCA may also be the basic accounts. This brings the reliability of any inflation accounting method in to question and perhaps supports the view that a suitable method is yet in the evolutionary stage.

¹. R.S. Gynther, "Accounting for changing prices; Developments in Australia and Overseas."
Recognition of gains or loss on monetary working capital:

So far recognition of gains or losses on monetary working capital is concerned most of the countries like the U.K., Australia, New Zealand, India and the International Accounting Standards Committee (IASC) are on the same footing. They suggested full recognition of gains or losses on working capital and inclusion of the same in the profit figure. But FASB-33 of the U.S.A. requires disclosure of gains or losses on holding net monetary items as a separate figure 'below the line' which is not to be merged with the profit figure and not to be segregated for holding monetary working capital and loan capital. Canada, however, proposes in its Re-Exposure Draft a peculiar treatment of monetary items by elimination of loss on holding monetary working capital from the profit statement and inclusion of monetary working capital in the calculation of the gearing adjustment.

Regarding the composition of the net monetary working capital figure, a minor difference may be traced between the U.K. and New Zealand, on the one hand and the Australia on the other. But it will not result in any significant difference in profit figures.

Regarding the treatment of gains on loan capital, New Zealand calculates full gains on loan capital. The U.S.A., also calculates full gains but it is done in conjunction with the
gains or losses on holding net monetary working capital. It is not included in the profit figure just like Australia which also calculate full gains on loan capital. The U.K. and India partially recognise the gains on loan capital by introducing gearing adjustment. Canada also gives partial recognition.

**Difference on capital maintenance concept:**

Difference also arises on the capital maintenance concept adopted. Australia adopts the operating capability of the entity. But, by segregating the capital maintenance Adjustment reserves in to the Gain on Loan Capital Reserve Account, and the current cost Reserve Account, the Australian model satisfies both the proprietary viewpoint and the entity viewpoint respectively.

New Zealand model is adopting a concept of maintaining only the operating capability of Shareholder's funds - and not the operating capability of the total entity - before allowing profit to emerge. ²

While FASB-33 of the USA uses a financial capital maintenance concept and the deduction of interest on long term borrowings to compute historical cost income from continuing operations indicate a propriety view of the business enterprise-a

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². Ibid. Page - 472.
view which is consistent with the financial concept of capital maintenance. U.K.'s SSAP - 16 incorporates a physical capacity (operating capability) maintenance assumption, but not based on either entity or proprietary capital maintenance methods. It is a hybrid, pragmatic compromise designed to get a maximum acceptance for CCA in the U.K. - and it seems that it might have succeeded in doing this.

Various committee reports on inflation accounting, India and abroad:

The major committee reports which help substantially in the growth of inflation accounting practice in India and abroad have been discussed under the following heads:

International Accounting Standards Committee:

This committee was founded on 29th June, 1973. The business of the committee is to formulate and publish and thereafter improve and harmonise the regulations, accounting standards and procedures relating to the presentation of financial statements. The business of the committee is conducted by a Board comprising representatives of accounting bodies of the selected countries.

The committee issued the International Accounting Standard No.6 (IAS No.-6) which summarised the main inflation accounting alternatives in the preface. The standard simply
requires the enterprises to "present in their financial statements information that describes the procedure adopted to reflect the impact on the financial statements of specific price changes, changes in the general level of prices or both. If no such procedure has been adopted that fact should be disclosed".  

The committee published the International Accounting Standard (IAS) - 15, titled "Information Reflecting the Effects of changing Prices" in November, 1981 which superseded the earlier standard (No - 6). This is applicable to large public enterprises in respect of financial statements covering periods beginning on or after January 1', 1983.

It recommends that such enterprises should disclose the following information using any method of adjustment for the effects of changing prices.

a) The amount of the adjustment to or, the adjusted amount of, depreciation of property, plant and equipment.

b) The amount of adjustment to, or the adjusted amount of, cost of sales.

c) A financing adjustment, if such adjustment is generally part of the method adopted for reporting information on changing prices.

d) The enterprise results, recomputed to reflect the effects of the item described in (a), (b) and (c), if necessary, and any other items to be disclosed separately.  

Where the current cost method is adopted, the current cost of inventories and of property, plant, equipment should be disclosed.

These informations are required to be disclosed on a supplementary basis unless inflation adjusted accounts constitute the basic financial statements. Both GPPA and CCA have been discussed in detail under chapter V. We have found that uptil now there is no international consensus on the subject and further experimenation is necessary before asking enterprises to prepare primary financial statements using a comprehensive and uniform system for reflecting price level changes.

Two points need to be stressed here. First, the standards issued by the IASC are recommendatory and not obligatory. Rather, the member bodies are obliged to work toward implementation and to the extent practicable under local circumstances. Second, the IASC has not entered in to any controversy in mentioning its preference in favour of a particular method to others. As result,

the issues at controversy do not change their nature and magnitude.

Sachar Committee Report:

The Indian Companies Act, 1956 does not contain any specific provisions which may ensure incorporation of the impact of price level changes in the accounts of a company. On the other hand it simply helps maintaining accounts as per historic cost accounting. Accordingly, the requirements of section 211 of the Act are not satisfied even when accounts are maintained truly in conformity with the provisions of the Act and schedules thereto. \(^5\)

Secondly, when accounting profit is overstated as compared to real profit, dividend paid on the basis of inflated accounting profit may be far in excess of what ought to have been otherwise paid and ultimately may amount to payment of dividend in the absence of profit which runs contrary to the provisions of section 205 of the said Act.

In spite of all these no proposal has been made regarding amendment in the Act to incorporate the impact of rise in price level in accounts.

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The Sachar Committee was appointed by the Government in 1977 to suggest changes in the companies Act 1956 and the MRTP Act 1969. The committee Report submitted in 1978 consisted of 600 recommendations of which 460 pertain to the companies Act. One of them was related to inflation accounting which suggested that - "in view of continuous increase in the prices, companies should make a provision by setting aside ten percent of their profits after tax as a replacement reserve provided that such a reserve should be treated at par with depreciation under the statutes of the country".

It is for the first time that a Government appointed committee made such recommendation on inflation accounting in this country. Even the draft companies Bill 1997 has not touched upon this aspect at all.

Raj Committee Report:

Raj committee on inflation accounting, which was in relation to distribution of steel in terms of current prices and its capital cost of per tonne, plays a significant role in the area of price level adjustment. The issue of a larger capital cost per tonne of product of Hindustan Steel Ltd (HSL) Vis-a-vis the TISCO and IISCO was underlined by the Raj Committee on steel distribution. It was argued in this report that in terms of more current prices the capital cost of the HSL was much higher per tonne of production capacity than was the case in some of the
older steel mills. This was an anomaly which could not be set right under conventional accounting practices. This affected comparability adversely and made price fixation inequitable. "Inflation accounting would level up the differences arising out of the varying age - groups to which individual companies belonged". In reality, a so called profitable company according to historical costs shown in the conventional profit and loss account and balance sheet might turn in to a losing concern according to current values, while a losing concern belonging to a smaller age groups might show up profits if inflation accounting was adopted.

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Sandilands Committee Report:

In January 1974, a committee of Enquiry into inflation, with F.E.P. Sandilands as the chairman, was appointed by the Government of the United Kingdom. The Sandilands committee or the Inflation Accounting committee submitted its Report in June 1975, which was presented to the British Parliament in September 1975. Sandilands committee recommended 'Current Cost Accounting' and its major recommendations are deliberated below:

1. Money is the unit of measurement.
2. Assets and liabilities are shown in the balance sheet at a valuation. The 'value to the business' criterion was supported by the committee for this purpose.

7. The terms of reference were "To consider whether and if so how, company accounts should allow for changes (including relative changes) in costs and prices, having regard to established accounting conventions based on historic costs, the proposal for current general purchasing power accounting put forward by the accounting standards steering committee, and other possible accounting methods of allowing for price changes and to make recommendations. F.E.P. Sandilands, Inflation Accounting, Report of the Inflation Accounting Committee. H.M.S.O. London 1977. Para - 5. Page - 1."
3. 'Operating profit' is arrived at after charging the 'value to the business' of assets consumed during the period. Holding gains should be excluded from operating profit and shown separately.

4. Current cost accounts should, as soon as practicable, become the basic published accounts of companies. However the net book value of assets on a historic cost basis and historic cost depreciation should continue to be shown in notes to the accounts.

5. C.P.P. Supplementary statements should not be attached to current cost accounts.

6. Companies should include a funds statement with their accounts, and directors of all companies should be required in future to include in their annual reports a statement on the adequacy of the cash resources likely to become available to meet the company's requirements in the ensuing year.

The other principal recommendations of the committee with regard to inflation accounting are :-

1. The rate of inflation will vary for different individuals and entities.

2. The movement in the Retail price index does not define the rate of inflation in a general sense.

3. The principles of accounting must be constantly reviewed to ensure that as far as possible they meet the requirements for information of those who use company accounts.
4. The rapid change in prices in recent years has had such a significant effect on the activities of companies that a re-examination is needed of the extent to which previously accepted accounting principles continue to meet the requirements of those who use company accounts.

5. A company's total gains for the year may be classified as
   a) realised or unrealised and
   b) holding, operating or extraordinary gains.

6. Accounting systems may be classified according to the unit of measurement used, the basis adopted for measuring net assets, and the extent to which total gains during a period are regarded as profit.

7. The unit of measurement may be either the monetary unit or a purchasing power unit.

8. Net assets may be measured by reference to their cost or to their 'value', and there is more than one basis of valuing net assets.

9. If monetary units are used as the unit of measurement, the value of assets consisting of money or near money will remain fixed and unalterable through time.

10. The three general bases of valuation of assets are current purchase price (replacement cost) net realisable value and economic value.

11. Most liabilities do not change in value in terms of monetary unit. However, certain types of liability may change in value.
12. Profit is an individual and subjective concept.

13. A new unit of measurement should be adopted only after serious consideration and if it can be demonstrated that it has significant advantages over the monetary unit.

14. So far as the measurement of net assets is concerned, the dominant requirement of users of accounts is for information on 'the value to the business' of a company's net assets. There is also a requirement for information on the historic cost of net assets and on their current value on other bases.

15. A concept of 'operating profit' appears to be more useful to many users of accounts than other concepts of profit. This distinguishes between holding, operating and extraordinary gains and regards only operating gains as profit for the year.

16. Most users of accounts require information on a company's liquidity position.

17. The monetary unit satisfies the principal criteria for a unit of measurement except that it does not have a constant 'purchasing power' when prices are changing.

18. The 'value to the business' of an asset owned by a company is in the great majority of cases represented by the current purchase price (replacement cost) of the asset, but may in certain circumstances be represented by its net realisable value or economic value.
19. 'Operating profit' is arrived at by charging against the amounts realised for a company's output during the year 'the value to the business' of the assets consumed in generating those amounts.

20. A company's liquidity position can best be shown by a separate cash flow statement supplementary to the accounts.

21. Directors should exercise great care in preparing internal forecasts of the future cash position of their company.

22. An accounting system should ideally be objective and possess other qualitative characteristics.

23. When prices are stable, historic cost accounts will provide satisfactory information on the 'value to the business' of assets.

24. Historic cost profit is a versatile figure providing information on profit calculated in different ways.

25. Considerable scope for the exercise of judgement is permitted by historic cost accounting. Historic cost profit is not intended to indicate a company's cash position.
The significance of inflation accounting also derived attraction from the accounting profession in the U.S.A, for which a committee was appointed to looked into its several aspect as discussed below:-

**Trueblood Committee Report**:

A great deal of research has been done into the objectives of accounting statements and price level adjustments. In October 1973, the American Institute of Certified Public Accountants (AICPA) published the report of their study group on "The objectives of financial statements," known as the Trueblood report after the Chairman of the study group, Mr. Robert Trueblood. This report is a comprehensive and valuable study of the objectives of accounts. The ASSC also engaged in a detailed study of the objectives of accounting statements as part of its forward programme of work. Research into this subject had been undertaken in a number of universities and members of the profession have made detailed and helpful contribution to the subject.

Similarly the Accounting profession in Australia also took initiative in examining the impact of Price Level Changes on Corporate Financial Statement.
**Mathews Committee Report**:

Mathews Committee, appointed by the Government of Australia in the month of December 1974 plays a vital role in the area of effects of inflation upon taxation policy. The committee submitted its recommendation in May 1975. Though the committee studied the effects of inflation upon taxation primarily, current cost Accounting (CCA) was the conceptual base of the recommendations. The committee pointed out various major adjustments need to be adopted during the course of current cost accounting. The Australian Accounting Research Foundation (AARF) brought out the recommendations of the said committee. The concept of CCA along with other concepts has been deliberated in chapter three.

**Ontario Committee Report**:

Ontario committe, appointed by the Government of Canada, submitted its report in June 1977 which looked into the area of Funds available for distribution or expansion. The main feature of the ontario committee Report is the voluntary supplemental

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funds statement disclosing impact of inflation pending development of current value system. As per the recommendation of the committee a supplementary schedule ought to be furnished along with the financial statement for funds available for distribution or expansion during the period of inflation.

**Review of various studies on inflation accounting in India:**

The effect of inflation on accounting based on historic cost has laid the foundation for a search of measures to counter the same. Though the attempts to evolve a suitable inflation accounting method had been started in the thirties of the current century in other parts of the world and though their efforts for a better measure are still continuing, India appears to have just started thinking over the problem. "The situation, therefore, is fluid and 'Inflation Accounting', as a subject is only in a nascent stage of development".  

The major research effort made by different academics and institutions are elaborated hereunder.


i) **Accounting for Price Level Changes by N. Misra (1982)**:

The author highlighted the nature of the problems those are encountered in times of inflation. These are followed by discussions on various adjustments and remedial measures specifically on the (a) Replacement Cost Accounting Method with its three important variants, namely Maintenance of real capital approach, Anticipated Cost Approach and Current Cost Approach (Popularly known as Current Cost Accounting Method); (b) General Purchasing Power Accounting Method; and (c) Real Replacement Cost Accounting method. The author recommended the general Purchasing Power Accounting method as the more desirable one in comparison to other methods justified by a case study of four companies covering a fourteen year period from 1961-62 to 1974-75 using March 31, 1961 as the cut-off point.

ii) **Inflation Accounting by Ramesh Gupta (1983)**:

This book provides self contained explanation of inflation accounting. It clearly describes with suitable illustrations the concepts of the three primary methods of inflation accounting, viz, current purchasing Power Method (CPP), Current Cost Accounting (CCA), and specific and General Price-Level Accounting (SPLA) which is a combined method of the earlier two, i.e. CPP and CCA. Then the major recommendations in the process of the developments of inflation accounting namely ED-8, ED-18 and Hyde Guidelines ED-24, SSAP-16 and FASB-33 have been discussed.
chronologically in reasonable detail with appropriate case studies. FASB-33 has been compared with SSAP-16. A separate chapter has been appended to discuss and review the position in India.

iii) **Inflation Accounting in a Developing Economy** by L.S. Prowal and N. Misra (1985):

This book is based on a macrostudy conducted by the authors to assess the inflation accounting practice followed by the large Indian business enterprises (80 out of sample of 235) and also to review the corporate altitude to the problem of inflation accounting. The authors have also obtained sample view points of some of the users of financial statements like investors, creditors etc.

iv) **Inflation and Accounting Theory** by Rajes Parchure (1987):

The primary aim of the author of this book is to reconstruct the theory of inflation accounting. "The distinguishing feature of the theory presented in this study is that the effects of changing prices on the economic conduct of a firm are traced with explicit reference to the interrelationship between the balance sheet and the income statement". 11

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In this study the author suggested a new method for inflation accounting. This method has been set out in chapter V having four important features.

a) Instead of "operating profit" as suggested by the sandilands committee (1975), the author laid emphasis on "disposable profit". The disposable profit concept is generalisation of the operating profit concept to the case where a part of the finances for assets may be borrowed.

b) The proposed method includes a gearing adjustment to arrive at the disposable profit.

The gearing adjustment proposed here is a generalisation of the one proposed in SSAP-16 (1980). The latter applies only to the case of a once-for-all increase in prices. The proposed method applies also to the situation where the rate of inflation changes from period to period.

c) Relative price changes are also covered by the proposed method.

d) The system of accounting for disposable profit possesses the properties of uniqueness and stability i.e. the figure for disposable profit does not fluctuate widely due to small changes in the dating of Balance sheets. One of the findings of the study reveals that the current Purchasing Power and the current cost approaches are infested with the error of double-counting due to which the profit figures become highly unstable.
It needs to be mentioned that inflation accounting has of late been included in the curricula of various academic and professional courses. Consequently, there are many text books containing one or more chapters to draw attention on the subject. Following are important amongst them.

(i) **Accounting Theory by S. Sengupta (1963)**:

It contains mainly a number of papers presented at conferences and seminars organised by the Indian Commerce Association. A chapter on Price Level Changes discusses some burning aspects, namely, the limitations of conventional accounting based on historic cost accounting and conversion of historic cost accounts into present value accounts etc. The book contains some important developments up to 1960 - 61.

(ii) **A Survey of Accounting Ideas by G.D. Roy (1963)**:

Part V of the book out of six parts, consisting of chapters 20-26 (PP - 307 - 420) has been titled as 'Accounting of changing Price Levels'. Chapter 20 (PP - 307 - 315) on 'Prelude to Replacement Accounting' discussed the following points after starting with a necessary introduction - Depreciation based on Historical Cost, Stock in trade and 'Expiration of capital outlay' and Introduction of new capital as a remedy. Next chapter

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is Replacement Accounting as applied to Fixed assets. "The impact of changing prices", in fact the evil effects of changing prices is the text of chapter-23. Remedies against adverse effects of inflation namely, Replacement methods, stabilized accounting and Maintenance of Resources methods have been discussed in greater detail. A separate chapter has reviewed the "Impact of rising prices on taxation". The last chapter deals with Accounting of Deflation and Conclusion.


The book contains a brief single chapter, i.e. chapter-15, (Pp - 340 - 350) on Inflation Accounting. The chapter started with a precise note on the need for a suitable inflation accounting method followed by a discussion on the limitations of historic cost accounting in Section I. Section II deals with the topic 'what is Inflation Accounting'? Four alternative approaches to historical cost accounting, namely, Replacement cost Accounting method, Revaluation method, write up method and Index method have been mentioned. Of all the methods Index method has been favoured by the authors as it possesses the distinctive features of inflation accounting. They have provided more emphasis on the next section which deals with 'How to determine current cost'? This section contains chronological discussion on the historical background of current Cost Accounting (CCA), salient features of CCA, limitations of CCA, interim recommendations of Hyde Committee and an illustration showing Depreciation adjustment, cost of sales adjustment and
Gearing adjustment. The fourth and the last section, "Inflation Accounting for management decision and control", shortly lays down a few suggestions which may help to implement inflation accounting for managerial decision making and control".\(^{13}\)

(iv) **Studies in Accounting Theory edited by Mukherji and Roy**:

This book is an edited version of a number of well selected articles on Accounting Theory. Chapter 16 deals with Inflation Accounting Contributed by B. Banerjee. Since a revised enlarged and up dated version on the same topic finds its place in Financial Policy and Management Accounting first published by the same author in 1984 and subsequently revised in 1987.

(v) **Financial Policy and Management Accounting by B. Banerjee (1987)**:

This book provided a major breakthrough in the development of inflation accounting practice in India. Seventh chapter of the book has been devoted to "Inflation Accounting". This chapter starts with a short introduction on the nature of the problems which are encountered under conventional accounting in times of inflation. The principles of various inflation accounting methods namely, Partial Adjustments, value Accounting

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(including Replacement cost Accounting, Present value Accounting, and continuously contemporary Accounting), cash flow Accounting, current Purchasing Power method (CPP) and current cost accounting (CCA) have been discussed in brief. Emphasis is given on CPP and CCA. The step by step conversion process under CPP is described in a lucid manner. Discussion on CCA starts with a brief historical underpinnings on the developments in the U.K. and covers (a) features and recommendation by the Sandilands Committee (b) features and recommendations of the Hyde Guidelines (c) features of SSAP-16 and (d) an appraisal of CCA method. Depreciation Adjustment, Cost of Sales Adjustment, Monetary Working Capital Adjustment, the current cost profit attributable to shareholders and the Holding gains are discussed with the help of illustrations. Next section entitled 'Inflation Accounting in Indian context' of the said book reviews the theoretical, legal and practical position of inflation Accounting in India.


Third of the four well divided sections of the book deals with 'Accounting for Changing Prices'. This section contains seven chapters, each chapter has been contributed by separate authors. The first of them (i.e. chapter 12 Pp - 185 - 234) entitled 'Costs (Historical versus Current) versus Exit values' has been written by Robert R. Sterling. Discussions have again been subdivided in to three sections. Section I is an attempt to differentiate clearly the three alternative methods of accounting
based on historic cost, current cost and Exit values. The second Section identifies the 'relevance criterion' in relation to a specified decision model, which helps the selection of the preferred alternative. The last Section shows the application of the identified criterion to other specific cases. Paul Rosenfield highlights on 'GPP' Accounting- Relevance and Interpretability' under chapter 13. It covers Evaluating the FASB proposal, General Purchasing Power Restatement, Improved information, Criticism on the Grounds of Relevance and Interpretability, FASB Position, Relevance of General Purchasing Power Information and a Good Step Forward. 'The state of current value Accounting' is the title of chapter-14 contributed by Edgar O. Edwards. Following points have been highlighted by the author- The currency of the Matter, Conceptual Issues, Issues of valuation and the Analytical uses of current value Accounting. Andrew M. Mc Cosh and Richard F. Vancil are the co-authors of chapter 15. titling 'Reconciling Sandilands with current Purchasing Power Adjustments.'

"An Enquiry in to the Theoretical Foundations of CCA' has been contributed by G.C.Maheswari under chapter-16. It is divided into four parts, Section I presents a historic profile to bring out the genesis of its evolution while part II describes the features of the system and presents the mechanism of measurement of business income and wealth. Part III enquires in to the theoretical underpinnings of the system and the last part records
concluding observations and suggestion.\textsuperscript{14} Next chapter 17 is on Accounting for the Effects of changing prices and has been written by J. Timothy sale and Robert W. Scapens. The points discussed are - The Gearing Adjustments, Comparison of SSAP-16 with statement No:33 and some Implications of the U.K. experiences. Reg. S. Gynther's contribution has been included in the last (Chapter i.e. 18, Page 322-332) bearing the title "Accounting for Monetary Items under CCA : A Comment.' After a brief introduction the author describes the following points- The Entity versus Proprietary Viewpoint Debate, The relevant Index Movement to Employ, The 'Denial' of Gains to Shareholders, Pricing and revenue etc.

Apart from the above, chapters 10 and 11 included in Section II of the book entitled "Concept of maintaining Capital Intact" and Maintenance of Capital Intact : An Unnecessary Abstraction ?' respectively and chapters 21 and 22 included in Section IV entitled Funds Statements under CCA and "A case for cash Flow Reporting" respectively have been contributed by R.N.Goyale one of the editors.


He has brought out the impact of inflation on the Financial statements of Tea companies in both Public and Private sector. The work has also highlighted working capital adjustments, Depreciation adjustment, Gearing adjustment and the impact of inflation on dividend payment. He has offered some suggestions for countering the effect of price level changes on corporate accounting and reporting.

**Inflationary cover in I.F.C.I's investment operations:**

Inflation is an important factor to be considered by a development bank in its investment decisions. The need for relating the operating policies/loan operations of a development bank to the phenomenon of rising prices is now well recognised. The problem pertains to maintaining the value of the assets of the development banks in the face of the constant threat of inflation. The effect of inflation on the working of a development financial institution (DFI) is aptly described by Hock in the following words -

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During an inflation, rising costs have probably increased the costs of operation of the bank. Salaries are likely always gone up. Supplies and other elements of the cost of operations of a development bank will have gone up too. Unless income is adjusted, the bank will be caught in a squeeze between fixed earnings and rising costs. Reduced earnings will jeopardise the ability of the bank to raise additional capital or to add its staff necessary technical competence or, indeed to perform any of its development functions.\textsuperscript{15}

The extent to which the Industrial Finance Corporation of India (IFCI) requires cover against inflation in terms of its liability structure, and the extent of such cover has been highlighted by a study in financial management sponsored by the Indian Council for Social science Research (ICSSR). Whether inflation affects an investor adversely or favourably depends primarily on:

1) How the investor's assets are divided between 'variable price' assets and 'fixed claim' assets; and

2) How large is the 'fixed claim' assets in relation to its 'fixed claim' debts.

Reasoning given above stems from the simple, well founded premise that fixed income/price assets donot provide hedge against inflation.

A comparison is made of the fixed claim liabilities of IFCI against its fixed income bearing portfolio. As foreign currency borrowings are vulnerable to exchange rate risks, the present exercise has been limited to local debts only.

**Conversion as an important element of the operational policy of I.F.C.I.**

Conversion which implies conversion of loans into equity is considered as an important element of the operational policy of IFCI. The practice followed by IFCI appears to be consistent with the basic rationale for introducing convertibility clause in early seventies on the recommendation of Dutt Committee. The committee had opined - rightly so - that the industrial enterprises enriched themselves by getting their projects financed by development banks, but the banks were not allowed to participate in the growing prosperity of these enterprises.

The profit made by conversion of loan into equity at a premium would help IFCI to strengthen its resources, to cover occasional losses and provide more funds for re-lending.

It has been recognised that equity investments provide hedge against inflation. Therefore, it was considered relevant to assess IFCI's equity investments pertaining to industrial enterprises in relation to its total assets. The investments in equity shares and the use of convertibility clauses seem to be
the only two potential means which IFCI can adopt for providing itself hedge against inflation, but the investment/operation policies of IFCI donot indicate that these two means are properly used.

Inflation is a reality, IFCI has to live with it and also survive. It is therefore, felt pertinent to touch upon the practices being followed by development banks in other countries. The important practices are :-

1) The sub borrower receives the loan denominated in dollars or denominated in some other foreign currency likely to remain stable throughout the period of the loan.

2) The loan gets tied to a domestic index such as that of prices, wages or cost of living.

3) The loan gets tied to a commodity shortening repayment period or requiring participation in profits and earnings.

However, the feasibility of the above measures being taken up by IFCI is to be seen against the background that in our country development banks have been conceived as instruments of state policy, they are expected to take in to consideration the public interest. Commercial profitability alone is not the criterion of their operations; they are to play a role consistent with socio economic goals of the country.
In consultation with the central government IFCI decided in 1981-82 to absolve the borrowers from the liability of losses arising out of the normal market fluctuations in exchange rate prevailing at the date of each payment. It is debateable whether this decision reflected the soft attitude of IFCI towards its borrowers or its willingness to take in to consideration the public interest consistent with the Socio-economic goals of the country.

The above instance may also suggest that measures like loan repayments tied to a relatively stable foreign currency; domestic indices such as that of prices, wages, cost of living, commodity etc. are not likely to find favour with IFCI. Therefore IFCI having been converted in to a Public Limited Company Since 1993 registered under the companies Act 1956, should devise new ways and means to meet the challenge of inflation.

**Participation of IFCI in the profits and earnings of the assisted units**:

There should be some form of participation of IFCI in the profits and earnings of the assisted enterprises. this concept is analogous to the practice of allowing sleeping partner(s) to share the profits of partnership business. The suggestion merits consideration, particularly in view of the fact that convertibility clause is not comparatively popular with IFCI. The reason may be that IFCI may not like to lock-up its funds in equities. The observation of Hock is significant in this context.
'This approach (conversion of debt into equity) can be dangerous especially with respect to liquidity, since in many developing countries the capital market is not well developed and since in periods of inflation uncertainty is likely to make the capital market function even more cautiously. However, it is potentially useful. In an inflation one might presume that the value of investments in land, machinery, plant etc will keep pace in value with rising prices since equity represents a share in these assets'.16

The policy of participating in the profits and earnings of assisted enterprises suggested above will have the potential to effectively counter the apprehension of liquidity problem as well as the uncertainty to both lender and borrower whether convertibility option will be exercised or not. Moreover, it will simplify the loan agreement, thereby saving a lot of time which IFCI can spend otherwise for the constant review to decide whether conversion should be applied, waived or retained.

However, as a matter of policy development Financial institutions and banks are usually debarred from participating in the earnings of the assisted units. They are only to get interest on the loan extended to the unit and thus to play the role of a catalytic agent.

Operational Impact of Inflation on Capital Investment decisions:

Capital Budgeting is essentially the process of encashing the prospective investment opportunities. The process involves the collection of data and information on viable alternatives, defining and estimating cash flows, determining the size of initial investment, followed by economic analysis according to the pre-determined selection procedure. In economic analysis, the effects of different assumptions, risk considerations, timing of cash flows and impact of inflation are to be assessed. During the last 40 years the academic literature has mainly concentrated on developing and refining quantitative evaluation criteria, measurement of cash flows, use of multiple cut-off rates, determination of discount rates, risk analysis techniques important factors for consideration and procedural aspects of capital budgeting. A very large number of studies have contributed to an approved investment analysis and decision making. But these studies by and large overlooked the effects of inflation in capital budgeting decisions.

Failure to consider the impact of inflation may lead to adverse effects for business firms which ultimately results in less than optimal allocation of resources. Bartley (1980) pointed out the following three main reasons for this -

1) As depreciation charges are based on historical costs, with the increase in inflation rates, depreciation remains under charged and larger taxes are paid. Larger taxes coupled with high inflation rate distort net return on investment.
ii) The required rate of return (cost of capital) from a project contains a premium for anticipated inflation. In the wake of inflation, gullible investors would require the nominal rate of return to be equal to the required rate of return plus the rate of inflation.

iii) Inflation also increases the risk factor associated with capital investments.\textsuperscript{17}

Generally, all prices do not increase at the same rate. High inflation may increase all expenses, but revenues may not go up at the same rate because of Government control and market competition. The inflation factor which influences cash flows significantly can not be over looked if a good investment decision has to be taken. Theoretical attempts were made earlier to develop more and more sophisticated rigorous mathematical analysis for incorporating the element of inflation in capital budgeting decisions.

\textsuperscript{17} Bartley J.W. A NPV model modified for inflation, "Management Accounting" December 1980.