Inflation Accounting—A meaningful challenge to conventional Accounting

By

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The conventional accounts are prepared on the assumption that money—the unit of measurement—is stable. It is presumed that no considerable change in monetary value takes place over a period of time. It is because of this assumption that in Historical Accounting we make adjustments for cost of goods sold, for valuation of assets and for depreciation on the basis of Historical Cost. But this assumption is not good in the real world when price level changes at a fast rate. During inflationary conditions, "Matching Concept" of conventional accounting is sacrified because current revenues for sales of goods are matched not with current cost of goods sold but with past or old cost of goods sold. Similarly depreciation reserves created on the basis of Historical cost of assets falls ruefully short of the replacement requirements. The effect of inflation have two ramifications. In the first place, the charge of depreciation is known at a lower than real level and henceprofits are all along overstated. Secondly if separate investments are made for replacement of old assets through depreciation funds, a tremendous cash shortage may occur when actual replacements are to be made. Under conventional accounting the value of assets stated in the Balance Sheet is also not the real value of the assets. Hence inflation does damage to the "real value" of the business. Although the business may be making gains in terms of "nominal" rupees, in terms of real worth, it may, in fact, be losing. Thus when there is inflation in the economy, the financial statements based on Historical accounting do not show true and fair view of the financial state of the company at the date of balance sheet, and of the results of the years activity. In general, the reported figures of profits are overstated and values of assets are understated when prices are rising. The ovestatement of income leads to :-

(i) taxation of capital

(ii) Return of capital as dividend, bonus, higher wages etc.

(iii) Financial strain on the capital, as less funds are available for investment. It becomes a case of self-imposed insolvency.

(iv) Figures reported are not relevant for management for decision making as decisions based on old figures will lead to distortions.

Mr. Peter Drucker has rightly observed "that during inflation the figure lie. The illusion of record profits leads to the wrong actions, the wrong analysis of the business, the wrong decisions, in Govt. gross mismanagement."

Hence, it is beyond doubt that a conscious adoption of anti inflationary policies is needed. Anti inflationary policies could cover the entire spectrum of financial management. Investment decisions, pricing decisions, financing decisions should all be taken after taking inflation effects into consideration.

The problem of inflation in accounts has been widely discussed under the term 'Inflation Accounting'. Two factors have made major contribution for the development of inflation Accounting.

(i) The double digit inflation during the seventies has made different users of financial statements to think over the nature of distortions caused by inflation in the historical accounts.

(ii) The development in this area in the U.K. and USA with the publication of statement of standard accounting Practice-SSAP-16 in U.K. and Financial Accounting Standards SAS-33 in USA.

Although H.W. Sweeney, the father of inflation Accounting, raised this problem of Inflation Accounting as back as in the year 1936 in his famous book 'Stablized Accounting' but most of the serious development and discussion on the subject has taken place after 1974. I would try to discuss briefly the major development which have taken place in this area in UK, USA and India.

As stated earlier it is true that a lot of work has been done in the area of accounting still no universally accepted approach or method has been developed so far· A lot of controversies still find their places of debate as :-

(i) Whether inflation accounting at all be adopted.

(ii) Whether adjustment for inflation be made for all items appearing in accounts or for only a few items.

(iii) Which method of inflation accounting be adopted.

(iv) Problems regarding choice of Index Nos.

(v) Problem regarding reporting of effects of inflation i.e. whether adjustment be made in historical statements itself or supplementary statements be prepared.

Broadly speaking two approaches are being advocated :—

(i) The Replacement Cost Approach	current value of that asset—Here specific price of asset is considered. It is also known as CCA, Current Cost Accounting.
(ii) Gereral Purchasing Power Approach (GPPA)	General price level changes—Use of Index Nos.

A suggestion has also been made for a combined replacement cost-cum-general purchasing power approach.

The different variants of the main approaches are :

(i) Replacement cost method covering fixed assets and/or inventories.

(ii) Writing up of fixed assets.

(iii) Present Value accounting.

(iv) Continously contemporary accounting.

(v) Current cost accounting.

(vi) General Purchasing Power accounting.

(vii) Replacement cost-cum-General Purchasing Power accounting.

Developments in U.K.

In January 1973, the British Accounting Standards Committee proposed for adopting inflation accounting into its Exposure Draft—8 "Accounting for changes in the purchasing power of money" (ED—8).

In May 1974, the provisional Statement of Standard Accounting Practice No. 7 (SSAP—7) entitled "Accounting for changes in the purchasing power of money" was issued. SSAP—7 requires that historical accounts be supported by a supplementary statement showing converted figures of all items on the Balance Sheet to pounds of purchasing power at the date of the balance sheet by multiplying by the factor :—

$$\frac{\text{Retail Price Index at Balance Sheet Date}}{\text{Retail Price index at date item arose.}}$$

But monetary assets and liabilities i.e. money and rights to stated amounts of money such as debtors, trade creditors, and loans are not so converted as they do not change their money value whatever happens to the price index.

In Jan. 1974, UK Govt. appointed 'The inflation Accounting Committee' with Sir Francis Sandilands as its Chairman. The Committee's report was published in Sep. 1975 and SSAP—7 was withdrawn.

The Sandilands Report repudiated CPP accounting as not providing useful information. Two main grounds of objection to CPP accounting were stated as follows :

(i) The usefulness of CPP accounting is always constrained by the deficiencies of the basic historic cost accounts. Sandilands was concerned about the changes in individual prices and pointed out correctly that CPP does not deal with these changes except in so far as the individual prices happen to move in step with General Index.

(ii) The purchasing power pattern of individual varies and that the concept of 'general price changes' is unquantifiable, Sandilands recommended the adoption of 'current cost accounting' (CCA). Under this system most assets appear on the balance sheet at their "value to the business". Value to the business is its written down current replacement cost (current purchasing price).

(a) Sandilands proposed that to calculate "current cost profit" adjustments should be made to the depreciation and cost of sales figures in the historic cost profit and loss account.

(i) Depreciation be provided on current value of assets to business instead of their historic cost.

(ii) Cost of Sales figures should be adjusted by taking current cost of each sales made instead of its historic cost.

The Accounting Standards Committee formed "Inflation Accounting Stearing Group" under chairmanship of Mr. Pouglas S. Morpeth to develop accounting standards to implement Sandiland's Committee report and as a result Exposure Draft—18 was issued in Nov. 1976. When this ED—18 appeared it seemed to be excessively complicated. The Institute of Chartered Accountants in England & Wales rejected the ED—18 because of three reasons :

(i) The method is not practical.

(ii) The system is not tested.

(iii) No provision for adjustment of monetary assets.

Hyde guidelines :

ASC appointed a working party chaired by Mr. William Hyde (Chief Accountant of the Oxford University) to prepare very rapidly for its approval an interim recommendation on inflation amounting. The report was published in Nov. 1977 Salient features of the report are :

1 It recommended that a separate statement be attached with the historic accounts after making following adjustments in the conventional financial accounts :

(i) Adjustment for depreciation: Depreciation be calculated not on historic cost of assets rather on the cost adjusted either by use of industry-specific or assets-specific published by the Central Statistical Office.

(ii) The cost of sales adjustment (COSA) should be calculated by the averaging method as described in connection with the Sandilands Report.

(iii) The gearing adjustment to reflect the position that a gain accrues to equity shareholders from an assets appreciation in value in so far as the assets has been financed by fixed interest borrowing.

II. The Guidelines also suggested methods for making above adjustments, but suggested that methods be used by the organisation which have not devised systems of their own.

SSAP-16

In March 1980 "Statement of Standard Accounting Practice 16 was published in March 1980 and is regarded as the biggest event in accounting in living memory.

(i) The Standards were in relation to annual financial statements for accounting period starting on or after Ist Jan 1980 but is recommended for earlier adoption, if possible.

(ii) The Accounting Standards were applicable only to big organisation having profit making as one of their objectives.

(iii) The report requires financial statements (Profit and Loss A/c and Balance Sheet) prepared both on historical cost basis as well as on current cost basis.

(iv) It suggested following adjustment in historical cost profit to derive the current cost profit:

(a) Depreciation adjustment.

(b) Cost of Sales adjustment and monetary working capital adjustment.

(c) Gearing adjustment in more cases where a proportion of the net operating assests is financed by net borrowings.

Developments in U.S.A.

In the early 1960s, the American Institute of Certified Public Accountants (AICPA) published study papers on reporting changes in replacement costs and using a supplementary statement to show the effect of General Price level changes. In 1969, the Accounting Principle Board Statement No. 3 recommended the publication of supplementary statements showing financial information adjusted for general price level changes.

The American Accounting Association (AAA) also advocated in its studies the use of current cost data for both the income statement and the balance sheet.

The Financial Accounting Standard Board (FASB) issued in Oct. 1979 statement No. 33 entitled "Financial Reporting and Changing Prices."

The requirements of this statement were.—

(i) Companies have to compute inflation's effect on profit in two different ways.

(a) CONSTANT DOLLAR METHOD : Adjusts inventory costs and depreciation for changes in the consumer price index since the related assets were purchased.

(b) CURRENT COST ACCOUNTING : Adjusts key items for price changes of specific assets that a company actually holds.

(ii) Recommendations were applicable to the companies :—

(a) If inventory and gross fixed assets are greater than $125 million

or

(b) Total assets net of depreciation greater than $ 1 billion at the begining of the financial year.

(iii) The disclosures are required for fiscal year ended on or after December, 1979.

(iv) It requires that adjusted accounts be prepared on supplementary basis.

Developments in India

The Federation of Indian Chambers of Commerce and Industry (FICCI) organised a workshop on inflation accounting in 1979 in Bombay and made following observations:—

(i) Project cost has arisen because of inflation.

(ii) In respect of Indian Companies, profits were expected to go down by 33% and several blue-chip Companies to show even negative profits if inflation adjustment was carried out.

(iii) It also highlighted negative features of inflation accounting as doubtful accuracy more paper work, expensive greater subjectivity affecting reliability of accounts, impossibility of replacement by identical assets.

(iv) The advantages mentioned are better corporate planning, inter-firm comparisons, performance evaluation, as well as maintaining operational capability. It helps management in decision making affecting, finance, expansion, pricing, dividents etc.

(v) The government, does not seem to have recognised adequatily the inflationary element while taxing income, capital gains or wealth of its citizens.

(vi) There is a need to create an awareness of the inflation accounting concept within the corporate sector, government shareholders, workers as well as the banks and other financial institutions.

(vii) The World Bank is increasingly recommending use of inflation accounting in evaluations. A few Indian Companies including BHEL have published inflation adjusted data in their annual report on an ad-hoc basis as supplementary data. Not much of the work on inflation accounting has been done in our country

The concerned professional bodies in India like the Institute of Company Secretaries, Chartered Accountants and Cost and Work Accountants should sit together with business, industry and Government to take bold steps of making a positive recommendation in this regard.

It is also necessary to develop reliable indices for use in inflation accounting and evolve a simple yet scientific system of inflation accounting which is suitable for the Indian conditions.

In Feb. 1982, the Institute of Chartered Accountants prepared a draft on Treatment of changing prices in financial statement. It is based on replacement price accounting. It also recommends that supplementary statements making adjustments in Historical accounts be prepared alongwith statements prepared on Historical basis