Inflation accounting

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Abstract

Inflation is a quantitative measure of the rate at which the average price level of a basket of selected goods and services in an economy increases over a period of time. Often expressed as a percentage, inflation indicates a decrease in the purchasing power of a nation's currency. As prices rise, they start to impact the general cost of living for the common public and the appropriate monetary authority of the country, like the central bank, then takes the necessary measures to keep inflation within permissible limits and keep the economy running smoothly. Inflation is measured in a variety of ways depending upon the types of goods and services considered, and is the opposite of deflation which indicates a general decline occurring in prices for goods and services when the inflation rate falls below 0 percent.

KEYWORDS: Inflation Accounting, Methods, Needs and Merits and Demertis

INTRODUCTION

Inflation accounting is a special accounting technique that can be used during periods of high inflation whereby financial statements are adjusted according to price indexes, rather than relying solely on a cost accounting basis. Companies operating in countries experiencing rapid and sustained levels of inflation or hyperinflation may be required to update their statements periodically in order to make them relevant to current economic and financial conditions. Also known as price level accounting.

INFLATION ACCOUNTING METHODS

There are two main methods — current purchasing power (CPP) and current cost accounting (CCA). Under the CPP method monetary items and nonmonetary items are separated. The accounting adjustment for monetary items is subject to recording of a net gain or loss. Nonmonetary items (those that do not carry a fixed value) are updated into figures with a conversion factor equivalent to price index at the end of the period divided by price index at the date of transaction. Under the CCA, both monetary and nonmonetary items are restated to current values.

NEED FOR INFLATION ACCOUNTING:

Accounting is based on the traditional concept of cost and revenue. Money is the yardstick for measuring profits and losses and financial health of the business — operating results and financial position. The basic objective of accounting is the preparation of financial statements in a way that they give a true and fair view of the business. That is, the income statement should disclose the true profit or loss made by the business during a particular period while the balance sheet must show a true and fair view

of the financial position of the business on a particular date. Financial statements are prepared in monetary units i.e., rupee. The medium of expression is the money value.

The value of money is itself fluctuating; any measurement with an unsteady scale cannot be finite and comparable. The recording of business transactions under the assumption that monetary unit is stable is known as historical accounting. However, it has been our experience that over a period of time, the prices have not remained stable.

There have been inflationary as well as deflationary tendencies. Rise in general price level, termed inflation erodes the intrinsic value of money, conversely, fall in general prices called deflation, raises its purchasing power. Inflation is a concept which every human being is not only aware of, but also painfully experiencing. The direct effect of inflation is the erosion in the purchasing power of money. The root cause of the problem is the change in the value of money.

Monetary unit is never stable and all types of countries have been experiencing high rates of inflation. The prices change as a result of various economic and social forces and such changes bring about a change in the purchasing power of money.

Unless the necessary adjustments are made, price level changes produce distortions in the financial statements and suffer serious limitations. Financial statements, prepared according to conventional or historical accounting system, do not reflect current economic realities.

The assumption of stable money value subject to which the financial statements are prepared is fallacious in the context of rising prices. Inflation by which we mean a rise in general price level and a fall in the value of money. Because historical rupee is not comparable to the present day rupee. Unlike physical units, such as kilogram, meter etc. are stable units in measuring weight and distance, monetary units i.e., rupee is an unstable unit of exchange value.

Consider the following example :

Capital Employed	8,00,000	Fixed Assets	8,00,000
Current Liabilities	2,00,000	Less : Depreciation	2,00,000
			6,00,000
		Current Assets	4,00,000
	10,00,000		10,00,000

Profit after tax @ 50% and depreciation of Rs. 80,000 (10% of the original cost of assets), the profit is Rs. 2,00,000. The replacement cost of the fixed asset is Rs. 15,00,000 due to inflation.

In the above example, the rate of return on capital employed is 25% , $\left(\frac{2,00,000}{8,00,000} \times 100\right)$ under historical accounting system. But when the profit is compared to the real value of the fixed assets, being used *i.e.*, Rs. 15,00,000, it would be clear that the rate of return on capital employed is not 25% as shown below :

Net Profit	Rs 2,00,000
Add: 10% depreciation on Rs. 8,00,000	80,000
Add: Tax @ 50% of profit before tax	2,00,000
Profit before charging depreciation and tax :	4,80,000
Less : 10% of depreciation on replacement cost of asset : Rs 15,00,000	1,50,000
	3,30,000
Less : Tax @ 50%	1,65,000
Profit on the basis of price level accounting	1,65,000
Capital employed on the basis of replacement cost :	
Fixed Assets	Rs 15,00,000
Less : Depreciation (as in historical accounting system)	3,75,000
	11,25,000
Add : Current Assets	4,00,000
	15,25,000
Less : Current Liabilities	2,00,000
Capital Employed	13,25,000
Rate of Return on Capital Employed $\frac{\text{Rs. } 1,65,000}{\text{Rs. } 13,25,000} \times 100$	12.45%

Thus it is clear that the profit is over-stated and the fixed assets are under-stated, when the effect of inflation is ignored. In this example, when the asset has to be replaced, larger funds are required on account of inflationary conditions. The asset purchased for Rs. 8, 00,000 and its life was expected to be 10 years, a sum of Rs 80,000 (10%) would be charged as depreciation every year. If after 10 years, the asset can be purchased for Rs. 13, 00,000, the firm may have to face serious problems because of insufficiency of funds. Hence, the need for inflation accounting.

MERITS OF INFLATION ACCOUNTING:

THE FOLLOWING ARE THE ADVANTAGES:

1. Since assets are shown at current values, Balance Sheet exhibits a fair view of the financial position of a firm.
2. Depreciation is calculated on the value of assets to the business and not on their historical cost—a correct method. It facilitates easy replacement.
3. Profit and Loss Account will not overstate business income.
4. Inflation accounting shows current profit based on current prices.
5. Profit or loss is determined by matching the cost and the revenue at current values which are comparable—a realistic assessment of performance.
6. Financial ratios based on figures, adjusted to current value, are more meaningful.
7. Inflation accounting gives correct information, based on current price to the workers and shareholders. In the absence of this, workers may claim for higher wages and shareholders too claim for higher dividends.

DEMERITS OF INFLATION ACCOUNTING*:*

1. The system is not acceptable to Income tax authorities.
2. Too much calculations make complications.
3. Changes in prices are a never ending process.
4. The amount of depreciation will be lower in times of deflation.

5. The profit calculated on the system of price level accounting may not be a realistic profit.

CONCLUSION

The two main groups of price indexes that measure inflation are the Index and the Producer Price Indexes. The GDP- and Price-deflator are also used. Interest rates are decided in the U.S. by the Federal Reserve. Inflation plays a large role in the Fed's decisions regarding interest rates since it uses inflation-targeting as a policy. In the long term, stocks and precious metals are good protection against inflation .Fixed assets shown in balance sheet become a meaningless conglomeration of resources purchased at varying costs in different years. The depreciation provision based on the original money investment of fixed assets represents and amalgam of costs incurred at various points of time and does not represent the same amount of purchasing power as was originally invested in the assets exhausted during operations. With inflation, the historical cost basis of depreciation widens the gap between the annual depreciation provision and the cost of used up portion of assets. As a result, the company faces difficulties in replacing the assets. Moreover, the depreciation provision when matched with sales at current prices leads to an inflated profit figure. In the balance sheet, assets are recorded at historical cost basis instead of current prices. Similarly, inventories are valued at their acquisition cost. Further, the historical cost of goods sold are matched with sales revenue at current prices.

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