A Study on Inflation Accounting in India

S.Vidhya
Ph.D - Research Scholars,Department of Commerce,Sri Ramakrishna College of Arts and Science for Women, Coimbatore, India

Abstract

The objective of financial reporting is to provide information about an entity which is useful to a wide range of users in making economic decisions. This study empirically investigates the utility of inflation accounting data to investors, by examining the ability of this data to explain the share prices of UK listed companies. Previous research supports a relation between historical cost accounting data and share prices from a conceptual and empirical perspective. Prior evidence from studies on the utility of inflation accounting data to investors is mixed. However, many of these suffer from methodological problems which cast doubts on their ability to evaluate the utility of inflation accounting data. This study overcomes some of the problems encountered in earlier studies and incorporates additional research design features. In evaluating inflation accounting data, this study explores whether or not company policy towards the disclosure of inflation accounting data in the premandatory period is associated with the explanatory power of this data. The investigation was undertaken for 2 periods to discover whether or not a learning lag exists in relation to the inflation accounting data. To achieve the objectives of this study, a recently developed cross sectional valuation model was used. The model incorporates measures from both the balance sheet and income statement, which allows the value relevance of key financial report disclosures to be assessed. The analysis reveals evidence supporting the utility of inflation accounting data to investors. The results show that a company's policy towards disclosing inflation accounting data in the premandatory period is associated with the explanatory power of this data. The significance of the inflation accounting data appears to be greater for the companies disclosing inflation accounting data in the premandatory period (Supportive Companies), than for companies which commenced disclosure in the first mandatory period (Reluctant Companies). There is also, evidence showing a differential response to the inflation accounting data for the Supportive and Reluctant Companies. The analysis fails to find any evidence of a learning effect in respect of the inflation accounting data.

KEYWORDS: Inflation Accounting, Techniques, Inflation Gap.

INTRODUCTION

Since we started understanding things around us, we all used to listen from our Grandparents about the things and articles especially Gold & Ghee being cheaper in their times. That time we used to think that why the things were cheaper in our Grandparents' time and why had they started becoming costlier. So this question would keep us puzzled. But now as we have grown in our knowledge and understanding, we have come to know about the phenomenon of Inflation which in layman's language is known as the state of rising pricing or the falling value of money was the greatest reason behind this.

Now emerges the question that what exactly is the Inflation?

Inflation is a global phenomenon in present day times. There is hardly any country in the capitalist world today which is not afflicted by the spectre of inflation.

Different economists have defined inflation in different words like Prof. Crowther has defined inflation "as a state in which the value of money is falling, i.e., prices are rising." In the words of Prof. Paul Einzig, "Inflation is that state of disequilibrium in which an expansion of purchasing power tends to cause or is the effect of an increase of the price level." Both the definition have emphasized on the rising prices of the goods.

The basic factors behind the inflation are either the rising demand or the shortening of supply due to any reason.

HISTORY OF INFLATION ACCOUNTING

In the last few years, inflation accounting has been adopted as a supplementary financial statement in the United States and the United Kingdom. This comes after more than 50 years of debate about methods of adjusting financial accounts for inflation.

Accountants in the United Kingdom and the United States have discussed the effect of inflation on financial statements since the early 1900s, beginning with index number theory and purchasing power. Irving Fisher's 1911 book The Purchasing Power of Money was used as a source by Henry W. Sweeney in his 1936 book Stabilized Accounting, which was about Constant Purchasing Power Accounting. This model by Sweeney was used by The American Institute of Certified Public Accountants for their 1963 research study (ARS6) Reporting the Financial Effects of Price-Level Changes, and later used by the Accounting Principles Board (USA), the Financial Standards Board (USA), and the Accounting Standards Steering Committee (UK). Sweeney advocated using a price index that covers everything in the gross national product. In March 1979, the Financial Accounting Standards Board (FASB) wrote Constant Dollar Accounting, which advocated using the Consumer Price Index for All Urban Consumers (CPI-U) to adjust accounts because it is calculated every month.

During the Great Depression, some corporations restated their financial statements to reflect inflation. At times during the past 50 years standard-setting organizations have encouraged companies to supplement cost-based financial statements with price-level adjusted statements. During a period of high inflation in the 1970s, the FASB was reviewing a draft proposal for price-level adjusted statements when the Securities and Exchange Commission (SEC) issued ASR 190, which required approximately 1,000 of the largest US corporations to provide supplemental information based on replacement cost. The FASB withdrew the draft proposal.

Still to cater to the needs of an Inflation Accounting, the IASB came out with an Accounting Standard known as IAS 29.

INFLATION ACCOUNTING IN INDIA :

"Inflation is like sin. Every Government denounces it and every Government practises it. " - Frederick Leith - Ross.

There has not been much debate or discussion in India on the subject of inflation accounting, although even the Government of India has realised the problem. Economic Survey : 1975-76 Para3.12 stated as under.

"There is now considerable evidence that the steep increase in costs of machinery and equipment in recent years is affecting not only new investment but also modernisation and replacement of ‘existing equipment. In a period of rising prices, depreciation formulae based on historical costs cease to provide adequate resources for the replacement of the existing worn out equipment. Moreover, in industries under price control, so long as the calculations
of permissible rate of return continue to be based on historic cost for fixed capital in use, there is a built in disincentive to new investment.....The problem of steep escalation in capital costs is, however, today a general problem facing Indian industry, and ways and means have to be 12 found to deal effectively with the same."

We discuss the development in this context under the following heading :

a) Professional developments
b) Government actions if any, and
c) Corporate Practices

A) PROFESSIONAL DEVELOPMENTS :

At the professional level, the developments can be examined from the viewpoints of the two prime Institutes of the accounting profession namely,

i) The Institute of Cost and Works Accountants of India (ICWAI) and,
ii) The Institute of Chartered Accountants of India (ICAI)

The ICWAI published only two books by its Research Directorate, namely, "Inflation Accounting; Tools and Techniques", 1975 by P. Chattopadhyaya and "Inflation Accounting as a Tool to Fight Inflation" 1975 by B. Murao. The ICWAI has preferred to remain silent so far as any guideline or inflation accounting method, to be followed either in connection with external reporting or decisional phenomena in the context of changing price levels is concerned. On the other hand, realising the urgency and importance of the matter, the Research committee of the Institute of Chartered Accountants of India published in its monthly journal, 'The Chartered Accountant' a discussion paper on 'Treatment of Changing Prices 13 in Financial Statements' in February 1982. It was only a discussion paper and not a definitive statement of the Institute. The committee recognised that a great deal of research and experimentation on the subject has already been conducted by various professional institutes, accountants and academics. Hence the main issue was in the opinion of the committee, "to examine how and to what extent the techniques of inflation accouning designed in Western Countries are apolicable to the Indian situation". Out of the many proposals that had been put forward for accounting for changing prices the following three were specifically considered :

i) Periodical revaluation of fixed assets along with the adoption of Lifo formula for inventory valuation.

ii) The current purchasing power accounting method.

iii) The current cost accounting method.

Thereafter, the Institute issued in December, 1982 a 'Guidance Note on Accounting for changing Prices' recommended by the Research Committee of the Institute for the "information and guidance of members". The Guidance note issued is not mandatory. The president of the Institute in his Forward to the Guidance Note stated :

"I earnestly urge upon the members to experiment with themethods of accounting for changing prices suggested in the guidance note, so that more experience can be gained in this regard".

Except for very few companies, not many business enterprises have experimented with inflation accounting while submitting reports to Shareholders. Even the companies who did publish inflation adjusted accounts did so generally irregularly. Nevertheless the steps taken by the institute are welcome. In the absence of any legal provision, the Guidance note, although recommendatory in nature, will definitely improve the situation in India.

B) GOVERNMENT ACTIONS IF ANY :

The companies Act, 1956, does not contain any specific provisions which may insure incorporation of the impact of price level changes in the accounts of a company. On the other hand, some of the provisions of the Act help maintain accounts in this sector according to the age-old 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 there to" 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 action in the form of suitable amenchment in the Act to incorporate the impact of rise in price levels in accounts appears to have been taken by the Government although the Act has been amended a number of times since its enactment in 1956.

In 1977 the Government appointed an 11 member committee known as the Sachar - committee to suggest changes in the companies Act 1956 and the MRTP Act 1969, "to make these Acts simple, easier to understand and more effective". The committee submitted its report in 1978 and of the 600 recommendations made by it, 460 pertain to the companies Act. One of them was relating to inflation accounting. It 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 significant that for the first time a Government appointed committee made such recommendation on inflation accounting in India. The responsibility to some extent lies with the premier professional institutes, the chambers of commerce in different parts of the country, the Bureau of public enterprises in particular and the accounting academics in general to make the Government conscious of the nature of the problems and ask for suitable amendments in the companies Act to incorporate in accounts the impact of change in price levels. The Income Tax Act 1961, also does not provide any incentive for inflation adjusted accounts. So, the relevant provisions of this Act should be amended as early as possible to allow tax-benefits to enterprises when they deviate from historic cost accounts. The statutes Government the financial sector do not also contain any provision regarding incorporation of the impact of price level changes in accounts. Similar actions need to be taken in these statutes as well.

C) CORPORATE PRACTICES :

The matter may be viewed from two aspects :

(a) External Reporting, and

(b) Use of inflation adjusted data for management decisions.

In may be mentioned that the existing provisions of the companies Act do not prohibit the adoption of measures of inflation accounting as evolved in other advanced countries of the world, either for external reporting or for internal decisional purposes. Since accounts under historic cost are required to be maintained till an amendment is made in this respect, except some partial adjustments, other measures for external reporting can be used only in the form of supplementary statements. Sorjie of the Indian companies belonging to public as well
as private sector attempts to present their annual accounts following the recommendations of SSAP-16 or CCA are commendable. As for example, the Hindustan Machine Tools even in its 26th Annual Report (1978-79) followed the Hyde Guidelines (P.P. 82-83) in preparing its annual accounts, similarly, Bharat Heavy Electricals Ltd, in its 15th Annual Report (1978-79) followed the principles of CCA as published in ED-18 and also Hyde Guidelines in presenting its annual accounts. Bharat Heavy Electricals., Steel Authority of India, Cement Corporation of India and a few other companies have been presenting in their annual reports a supplementary inflation adjusted accounts. Regarding the private sector, it can be stated that the Indian Institute of Management, Ahmedabad made a Survey in 1978 of 200 companies. The general picture regarding corporate practices may be better understood from the findings of'a research study relating to 80 large private and public sector companies in India for the accounting year 1979-80. All the companies preparing adjusted information followed either the CCA method or some variant of replacement cost accounting. Regarding the nature of adjustments, it may be stated that almost all the companies adjusted the most important factors affecting the historical cost accounts during inflation viz.

a) fixed assets and depreciation thereon, and
b) cost of inventories consumed.

Monetary items, however, did not attract due attention of the managers. It is important to note that many companies in India have been taking in to account inflation adjusted data for managerial decisions even though they are not showing supplementary inflation adjusted accounts for external reporting purposes. Capital budgeting, working capital management, dividend decision etc are examples on the point. In the way of adopting inflation accounting, for external reporting purpose in India the main obstacles are :

a) Practical difficulties in its implementation.
b) Difficulty in understanding such accounts.
c) Non acceptance of the inflation adjusted accounts for tax purposes.

There is a general feeling that a high powered committee on the lines of Sandilands committee of U.K. should be appointed to study the problem before introducing any solution. The committee should define objectives, develop concepts and standards and then finally suggest a suitable system of inflation accounting.

EFFECT OF INFLATION ON BUSINESS

The impact of inflation on business can be bifurcated into two parts like

1. Impact on costs and revenue
2. Impact on assets and liabilities

As far as impact of inflation on costs and revenues is concerned, definitely both will rise but whether they result into extraordinary profits will be determined by that how much opening stock was available at old prices with the company and how much later the demand for increasing wages is entertained by the company. In case of monetary assets and liabilities, a company will lose in case of being creditor and gain in case of being debtor in real terms. If we talk about other assets like building, land and other securities, the company will be having holding gains in monetary terms but may have neutral impact in real terms due to the rise in prices on the one hand but fall in value of money on the other.

CONCEPT OF INFLATIONARY GAP

Real inflation, according to Keynes comes in to being only if monetary expansion continues even beyond the point of full employment. Then every additional expansion of money supply
shall exert- its full effect on prices, raising them to higher and higher levels. Keynes tried to explain the phenomenon of inflation in terms of his well known concept of inflationary gap
in his famous pamphlet entitled - How to pay for the war ? Keynesian concept of inflationary gap represents the technique of statistically measuring the pressure of inflation in the economy. If scheduled investment tends o be greater than full employment saving, then more goods will be demanded of business than it can produce, and prices will begin to rise.

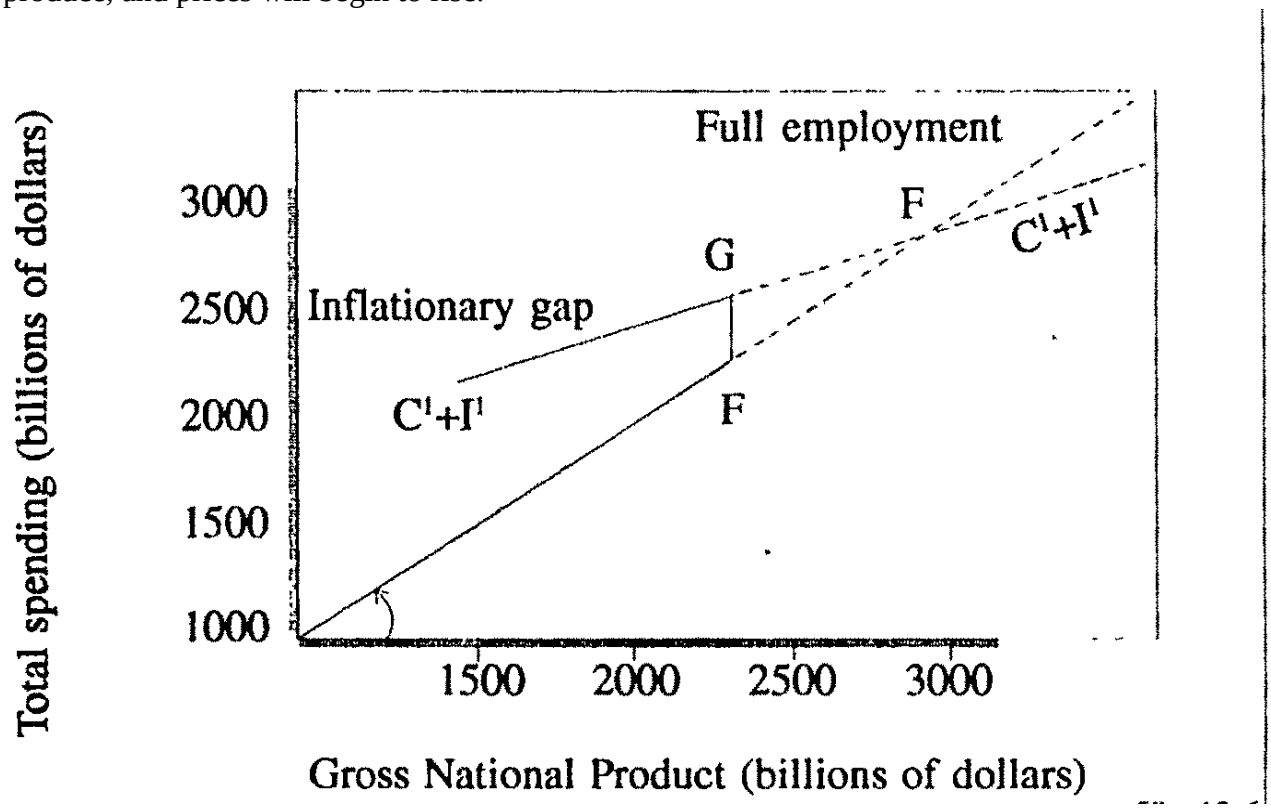

Fig - 1 shows how to measure the inflationary gap as vertical distance. The new C* + I ' curve lies above the 45° line at the full employment level by the distance FG' giving us an inflationary gap of $200 billion. It full employment saving falls short of scheduled investment at full employment, there is said to be an "inflationary gap". its

size being measured by the excess of the C + I schedule above the 45° limits full employment level.

INFLATION ACCOUNTING AND ITS SIGNIFICANCE

The impact of inflation comes in the form of rising prices of output and assets. As the financial accounts are kept on Historical cost basis, so they don't take into consideration the impact of rise in the prices of assets and output. This may sometimes result into the overstated profits, under priced assets and misleading picture of Business etc.

So, the financial statements prepared under historical accounting are generally proved to be statements of historical facts and do not reflect the current worth of business. This deprives the users of accounts like management, shareholders, and creditors etc. to have a right picture of business to make appropriate decisions.

Hence, this leads towards the need for Inflation Accounting. Inflation accounting is a term describing a range of accounting systems designed to correct problems arising from historical cost accounting in the presence of inflation.

The significance of inflation accounting emerges from the inherent limitations of the historical cost accounting system. Following are the limitations of historical accounting:

1. Historical accounts do not consider the unrealised holding gains arising from the rise in the monetary value of the assets due to inflation.
2. The objective of charging depreciation is to spread the cost of the asset over its useful life and make reserve for its replacement in the future. But it does not take into account the impact of inflation over the replacement cost which may result into the inadequate charge of depreciation.
3. Under historical accounting, inventories acquired at old prices are matched against revenues expressed at current prices. In the period of inflation, this may lead to the overstatement of profits due mixing up of holding gains and operating gains.
4. Future earnings are not easily projected from historical earnings.

TECHNIQUES OF INFLATION ACCOUNTING

To measure the impact of inflation on financial statements, following are the techniques used:

1. Current Purchasing Power (CPP) Method

Under this method of adjusting accounts to price changes, all items in the financial statements are restated in terms of a constant unit of money i.e. in terms of general purchasing power. For measuring changes in the price level and incorporating the changes in the financial statements we use General Price Index, which may be considered to be a barometer meant for the purpose. The index is used to convert the values of various items in the Balance Sheet and Profit and Loss Account. This method takes into account the changes in the general purchasing power of money and ignores the actual rise or fall in the price of the given item. CPP method involves the

refurnishing of historical figures at current purchasing power. For this purpose, historical figures are converted into value of purchasing power at the end of the period. Two index numbers are required: one showing the general price level at the end of the period and the other reflecting the same at the date of the transaction. Profit under this method is an increase in the value of the net asset over a period, all valuations being made in terms of current purchasing power.

2. Current Cost Accounting (CCA) Method

The Current Cost Accounting is an alternative to the Current Purchasing Power Method. The CCA method matches current revenues with the current cost of the resources which are consumed in earning them. Changes in the general price level are measured by Index Numbers. Specific price change occurs if price of a particular asset changes without any general price change. Under this method, asset are valued at current cost which is the cost at which asset can be replaced as on a date. While the Current Purchasing Power (CPP) method is known as the General Price Level approach, the Current Cost Accounting (CCA) method is known as Specific Price Level approach or Replacement Cost Accounting.

LIMITATIONS OF INFLATION ACCOUNTING

Though Inflation Accounting is more practical approach for the true reflection of financial status of the company, there are certain limitations which are not allowing this to be a popular system of accounting. Following are the limitations:

1. Change in the price level is a continuous process.
2. This system makes the calculations a tedious task because of too many conversions and calculations.
3. This system has not been given preference by tax authorities.

CONCLUSION

Every person on this earth has been affected by Inflation, some positively but most of the people negatively because the Inflation leads to the erosion of general purchasing power. The Inflation spares none and it equally influences the Businesses like the people. Historical cost accounting does not take into account the changes in the rise in the value of assets and its impact on Balance Sheet and P&L Account due to inflation and does not reflect the real worth of the business which is very required for effective decision making. Inflation Accounting has removed this drawback by providing methods for adjusting the figure according to General or Specific Price levels. Despite a right method of presenting financial statements, Inflation Accounting is still not widely prevalent due to certain limitations. But with more research and development of accounting software in this field, there is no doubt that Inflation adjusted accounting is the future of Financial Accounting.

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