Inflation Accounting

T. Charles Victor
Asst. Professor and Hod of Commerce (PA), Erode Arts and Science College (Autonomous), Erode, India

Abstract

Inflation Accounting is not a new field of study. Since the beginning of the twentieth century efforts have been made to adjust the accounts to reflect changes in price level. The approach taken by each country to inflation accounting is influenced by a number of factors. The urgency of the need to find a solution to the problem depends on the rate of inflation for an individual country. Inflation has an effect on consumer prices, to be sure, but there are effects on corporate finance as well. Typically, in developed countries, inflation rates are fairly steady and somewhat predictable. However, in times of hyperinflation, prices soar and corporate financial reports can be misinterpreted without accounting for inflation. Inflation accounting offers a more accurate view of a company or individual's financial situation because it looks at those finances through the lens of inflation. The paper discuss about how the Inflation accounting is conceptualized in terms and how government can act at a distance upon management, economic organizations and other institutions.

KEYWORDS: Inflation Accounting, Price level, Management, and Economic organizations

Introduction:

According to Investopedia "Inflation accounting requires statements to be adjusted according to price indexes, rather than rely solely on a cost accounting basis." 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.

The inflation accounting school (I.A.S) has gathered a large number of committed supporters, staunch converts, reluctant converts spread all through academia, business, Government and legal bodies. The inflation accounting school itself is neither homogenous nor unanimous but their front against HCA is a united one. There are two major conflicting approaches within the inflation accounting school. These are the Current Purchasing Power Approach (CPPA) or General Purchasing Power Approach (GPPA) and the Current Cost Accounting Approach (CCA).

Objectives of the Study

- The system of inflation accounting should be such that, with minor modifications, If it will yield the necessary information to moderate proper management action.
- Basically methods have been recommended to adapt financial statements for inflation accounting.

Objectives of Inflation Accounting

- To portray the real profit or loss for the period under consideration as against the profit or loss on the basis of historical costs;
- To set out the real financial position, in present day terms rather than the conventional position on historical costs basis and to indicate the real capital employed;
- To ensure that sufficient funds will be available to replace the various assets when the replacement becomes due; and
- To indicate profits in constant rupees, i.e., having regard to the general movement in prices for the guidance of shareholders as well as of management.

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.

Purchasing Power

Inflation raises prices, thereby decreasing purchasing power. The same amount of money will not purchase the same amount of goods ten years later when inflation is taken into consideration. For instance, what would happen if an individual planning for retirement calculated the number of years he or she expected to live after retirement and multiplied their current salary by that number of years to come up with the sum total they would need to save to cover their Cost of Living for retirement? If they did not account for inflation, their retirement nest egg would dwindle long before their life ended.

Price Inflation vs Monetary Inflation:

Technically, **Price Inflation** is when prices get higher or it takes more money to buy the same item and this is what people commonly think of when they hear the word inflation.

Monetary Inflation is an increase in the money supply which generally results in price inflation. This acts as a “hidden tax” on the consumers in that country and is the primary cause of price inflation.

Monetary inflation is commonly referred to as the government “printing money” although the actual process is a bit more complex than just cranking up the printing presses but the effects are essentially the same.

As the money supply increases the currency loses it’s purchasing power and the price of goods and services increases. In a large economy like that of the U.S. this process usually takes 18 months to 2 years so the government is able to spend the newly minted dollars at the old value before consumers realize that they have been cheated into accepting something that will purchase less than they originally thought it.

Monetary and Non-Monetary Items:

In converting the figures in the basic historical cost accounts into those in the supplementary current purchasing power statement a distinction is drawn between:

(a) Monetary items; and

(b) Non-monetary items.

Monetary items are those whose amounts are fixed by contract or otherwise in terms of numbers of pounds, regardless of changes in general price level. Examples of monetary items are cash, debtors, creditors and loan capital.

Holders of monetary assets lose general purchasing power during a period of inflation to the extent that any income from the assets does not adequately compensate for the loss; the converse applies to those having monetary liabilities.

A company with a material excess on average over the year of long, and short-term debts (e.g., debentures and creditors) over debtors and cash will show, in its supplementary current purchasing power statement, a gain in purchasing power during the year.

This is a real gain to the equity shareholders in purchasing power but it has to be appreciated that there may be circumstances in which it will be accompanied by a dangerously illiquid situation or by excessively high gearing and for this reason any such gain should be shown as a separate figure.

It has been argued that the gain on long-term borrowing should not be shown as profit in the supplementary statement because it might not be possible to distribute it without raising additional finance. This argument, however, confuses the measurement of profitability, with the measurement of liquidity.

Even in the absence of inflation, the whole of a company's profit may not be distributable without raising additional finance for example because it has been invested in, or earmarked for, investment in non-liquid assets.

Moreover, it is inconsistent to exclude such gain when profit has been debited with the cost of borrowing (which must be assumed to reflect anticipation of inflation by the lender during the currency of the loan) and with depreciation on the converted value of fixed assets.

Non-monetary items include such assets as stock, plant and buildings. The retention of the historical cost concept requires that holders of non-monetary assets are assumed neither to gain nor to lose purchasing power of the pound (but see paragraphs 21 and 22 below).

The owners of a company's equity capital have the residual claim on its net monetary and non-monetary assets. The equity interest is therefore neither a monetary nor a non-monetary item. The conversion process

In converting from basic historical cost accounts to supplementary current purchasing power statements for any particular period

(a) Monetary items in the balance sheet at the end of the period remain the same;

(b) Non-monetary items are increased in proportion to the inflation that has occurred since their acquisition or revaluation (and conversely, reduced in times of deflation).

In the conversion process, after increasing non-monetary items by the amount of inflation, it is necessary to apply the test of lower of cost (expressed in pounds of current purchasing power) and net realizable value to relevant current assets, e.g., stocks, and further to adjust the figures if necessary.

Similarly, after restating fixed assets in terms of pounds of current purchasing power, the question of the value of the business needs to be reviewed in that context and provision made if necessary.

Other matters that will need to be considered include the adequacy of the charge for depreciation on freehold and long leasehold properties and whether it may be necessary to include in the deferred tax account in the supplementary statement, an amount for the corporation tax (in the Republic of Ireland, income tax and corporation profits tax) on any chargeable gain which would arise on sale of the assets at the date of the balance sheet at the amount shown in the supplementary statement.

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.

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