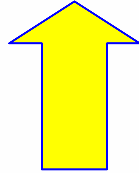
Chapter Nine

Inflation Accounting



Summary

What is Inflation?

Inflation means an upward change in the prices of goods and services of general consumption. Prices reflect the value of goods and services in the economy. Price changes occur when the price of goods and services vary from what they were previously. Price changes are classified as a) General, b) Specific and c) Relative price changes.

Why Inflation Accounting?

Inflation Accounting seeks to address the inherent limitations of historical cost accounting. Under historical cost accounting the profit figure is derived by matching costs against current revenues. Such costs are historical and not current costs. For example, depreciation, purchases, etc. are shown at historical costs. This results in under statement of cost and over statement of profits.

Inflation accounting is claimed to be a superior accounting that reflects effect of changing price levels.

Need for Inflation Accounting.

i) Inflation adjusted profit:

Traditional historical cost based accounting does not adjust to income, depreciation and materials charges at current price levels.
This results in higher book profits.

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If these are distributed to shareholders as dividends, it can lead to capital erosion.

ii) Replacement of assets :

Traditional historical cost based accounting provides for depreciation that is inadequate to finance the replacement of depreciated assets. Here by replacement it is not generally meant the replacement of one asset by an identical second asset. We mean replacement of the operating capability represented by asset that needs replacement.

The book value of the asset indicated during its life under normal accounting is also under stated. An asset bought at Rs. Ten lakhs, will show a book value of Rs Seven lakhs at the end of three years under 10% SLM of depreciation. At that time its market value is nearer to Rs Twelve lakhs indicating a requirement of Rs Five lakhs accumulated depreciation, against only three lakhs provided in the books of accounts.

iii) Maintenance of real value of capital ;

Maintenance of capital means maintenance of

a. Financial Capital and
b. Physical Capital.

Financial Capital maintenance is measured in either nominal monetary units or units of constant purchasing power. In traditional accounting although capital is maintained in nominal money terms, it may not be maintained in real terms. Profit calculated after maintaining capital only in nominal money terms is not real profit, especially under inflationary conditions. Any decision taken on this ‘paper profit’ is misleading.

iv) True and Fair view :

Primary objective of Financial Statements is to provide true and fair view of the profit and loss for the accounting period and true and fair value of assets and liabilities as at the end of the period. These objectives are not achieved under historical cost based accounting.

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v) Effective composition :

Comparison of the profits earned by a company over years is rendered useless by accounting based on historical costs. A company earning a profit of, say Rs. Five crores four years ago, and Rs Ten crores now ; cannot be said to have improved its profitability , because shareholder is likely to find that with Rs Ten crores now, he may not be able to buy what he would have bought with only Rs Five crores four years ago!

Method of Accounting for Inflation

There are two methods of accounting for price level changes as below –

A] Current Purchasing Power (CPP) &
B] Current Value Systems

Current Purchasing Power (CPP)

The CPP accounting was favored by the accounting profession in 1970's. The fundamental aim of CPP accounting is to show the effect of inflation in the purchasing power of the equity interest. CPP accounts are derived directly from historical cost accounts and are, therefore, largely based on GAAP.

The steps under CPP –

a) Convert beginning of the year figures in the conventionally prepared balance sheet into rupees of purchasing power as under –

    i] adjust non monetary items for changes in the purchasing power since they were acquired or revalued,
    ii] do not adjust monetary items like current assets & liabilities, as by definition they are expressed at current purchasing power.

b) Convert above data from purchasing power at the beginning of the year to the purchasing power at the end of the year.

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c) Convert figures at the end of the year in the balance sheet to purchasing power at the end of the year, following procedure under step a) above.

d) The difference between the total equity interest in the converted balance sheets at the beginning and end of the year (after allowing for dividends and introduction of new capital) is the profit or loss for the year measured in current purchasing power.

e) The profit and loss account can be prepared to get inflation-adjusted profit or loss by expressing the relevant figures in rupees of purchasing power at the end of the year.

Current Replacement Cost (Entry Values)

In this system, current replacement cost is used as the measurement base,. Replacement costs are of two types

i) the current replacement cost (CRC) and
ii) the net current replacement cost (NCRC)

The CRC refers to the cost at which an asset can be replaced in the normal course of business at the balance sheet date or at the date of sale, whichever is relevant.

NCRC is used for conversion of fixed assets only. NCRC conversion of fixed assets is calculated by determining gross replacement cost at the balance sheet date, less a proportionate deduction for accumulated depreciation.

Limitations of Replacement Cost Accounting

1] Estimation of current replacement costs at particular dates involves subjective judgments and

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2] By itself, replacement cost accounting is not a comprehensive system of accounting for price changes. It fails to take into account the effect of price changes on monetary items.

Economic Value Method

Under this method, the current value of an individual asset is based on the present value of the future cash flows that are expected to result from the ownership of the asset. These values are calculated from :

(a) the estimated cash amount of the future benefits
(b) the timing of these benefits ; and
(c) an appropriate discount factor (like cost of capital to the company)

Estimated future cash flows are rarely realizable and are subjective ; and this is the main charge against this method.

Conclusion

Discussion on this subject gained momentum when annual inflation was in double digits. But the tempo has died down with the fall in inflation.

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