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A Critical study of Inflation Accounting

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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.

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.

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. 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.

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.

Techniques of Inflation Accounting

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

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.

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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