INFLATION ACCOUNTING: MORE QUESTIONS THAN ANSWERS

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ABSTRACT

The sole responsibility of accounting is to present what has transpired within a given period through reporting not what should have occurred or will occur. Despite fitting correctly into the definition of reporting business event, historical cost accounting in recent times has come under heavy criticism of lacking behind economic trends due to the use of original cost. Historical cost accounting has been challenge on principles of uniform monetary measure and matching concepts. These growing dissatisfaction with historical cost accounting as a method of reporting financial statements has made it necessary to consider alternative method which is accounting for price level changes. Unfortunately, this alternative has not been put to practice due to its unattractiveness. It is against this background that this paper attempts to discuss some novel questions with recommendations about the existing inflation accounting methods.Aside the traditional disadvantages of inflation accounting, this article have critically examine the restatement of items under inflation accounting against basic accounting, economics and finance principles. In addition the novel questions have been raised on the consistency and rationale behind the treatment of certain items under price level changes accounting. The article argues that, inflation accounting is not only inconsistent with accounting principles but also with related subjects such as economics and finance. In practice inflation accounting creates illusionary or imaginary profit which does not exist, thus capital maintenance concept is just a paper theory because much of the profit under inflation accounting is unrealised or holding gain Inflation

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accounting distorts the basic objective of reporting what happen within a period or at specific time. The greatest deterrent to adoption of price level changes accounting is what it is not: inflation accounting is not present value, net realizable value, or current market values or fair value and therein lies much of the opposition to its use .In line with these questions, the article recommends that, inflation accounting can only be meaningful with new accounting system since the existing system is based on historical cost accounting.

INTRODUCTION

The sole responsibility of accounting is to present what has transpired within a given period through reporting not what should have occurred or will occur. According to Microsoft Encarta 2009 report means to "give information about something that has happened". This implies that financial report should provide information of what happen in a company but not what is supposed to happen. Simple meaning of report is giving information about past event not projections. This concept of financial reporting gave birth to historical cost accounting which reports what has happen in business. Despite fitting correctly into the definition of reporting business event, historical cost accounting in recent times has come under heavy criticism of lacking behind economic trends. Different scholars have challenged historical cost accounting on various accounting principles chiefly on uniform or common monetary unit and matching concept.

The Uniform or common monetary unit measurement concept holds that all accounting items should be recorded at constant value of monetary units at the same time. By preparing accounts we use monetary value usually currency. India rupee is used for recording financial transaction in India. This rupee has two value face value/nominal and real value. The face value is the number written on the currency whiles the real value is the purchasing power of the currency. That is how much of goods the currency can buy. How will a company record the total value of land such as on 1/4/1981 Rs 1600 per plot, in 16/9/2009 Rs 15000 and in 2/9/2014 Rs 28000? The historical cost reporting of the sum Rs 44600 does not employ uniform monetary unit because they are at different price changes. Thus in historical accounting values of incomes and expenses, assets and liabilities are mix together depending on the date ate which each item was originally acquired. To apply the uniform monetary unit concept, the individual price must be restated at a constant monetary unit through price indices. Such treatment will reflect the true value of the company's assets. The challenge to historical cost accounting is that it assumes no inflation or rate of inflation can be ignored. This cause under valuation of old assets and its ultimate decrease in the value of the company. By matching principle or concept revenue must be matched with cost at which the revenue was generated. That is the current revenue must be match with current cost. Historical accounting matches both historical cost and current cost with current revenue thereby yielding a mismatch. This mismatch leads to understating cost and overstating profit which might cause eroding of capital if profit is distributed.

In simple terms historical cost accounting does not disclose true profit that can make the company maintain its capital. For example if depreciation is charge on cost of an asset which was bought five years ago against revenue earn today, depreciation expense will be less and profit will be higher giving high dividend and tax payment resulting to capital erosion. These growing dissatisfaction with historical cost accounting as a method of reporting financial statements has made it necessary to consider alternative method which is accounting for price level changes. Accounting for price level changes simply put as inflation accounting report financial activities by adjusting historical cost values with the effect of inflation mostly through inflation indices and market price of assets. Whilst it has been welcomed and hailed by many professionals, inflation accounting has not been put to much practice since its introduction in the 20th century. Many people have raise lot of concerns such as its complexity, subjectivity, costly and above the use of indices. Inflation accounting provides breeding ground for creative accounting due to its judgemental nature to the disadvantage of the innocent investor. These limitations of price level changes accounting lead to the withdrawal mandatory disclosure status in the UK and USA where it originated. The unattractiveness of inflation accounting method raises more questions than answers. It is against this background that this paper attempts to discuss some novel questions with recommendations about the existing inflation accounting methods.

CONCEPTUAL FRAMEWORK

As the world changes, everything within including price also changes. Price changes occur only when the prices of goods or services are different from what they were previously in the same market. In a free market as ours where demand and supply rule the market Price can never be same forever therefore nothing under the sun can escape from its effect including accounting information. With this basic principle, the accounting profession has attempted reflect the impact of price level changes on financial reporting. As rightly, put out by Smith and Anderson, inflation accounting information reveal changes in corporate performance and position beyond historical cost information. Since Irving Fisher's *The Purchasing Power of Money* book in 1911 accounting bodies have continuously pursuit viable methods for addressing inflation on financial accounting. Though no consensus has been reach on the best methods from the many alternatives, General Purchasing Power and Current Cost Accounting are the most commonly practice. General Purchasing Power Accounting (GPPA) has different names such as Current Purchasing Power Accounting, Constant Dollar Accounting and Constant Purchasing Power.

Accounting. GPPA This method adjusts historical costs for changes in the general level of prices as measured by a general price level index. It restates financial statement items into currency (eg Indian Rupees) that have equal purchasing power. GPPA methodology multiple historical cost values by conversion factor which is the ratio of the price-level index at the date of conversion and price level index at the transaction date. Items in the balance sheet are classified into monetary and non-monetary items with the later been restate at by indices whiles the former are recorded at their historical values. Further purchasing power gain or loss which is adjusted in the profit and loss account is calculated on monetary items. The resultant effect of GPPA is financial capital maintenance. FAS 33 in USA is aligned with this method of inflation accounting

CCA uses value to the business as the measurement basis. Value to the business is defined as net replacement cost or recoverable amount. CCA aims to maintain capital of a business enterprise in terms of its operating capability (physical capital maintenance). Unlike GPPA where all items under profit and loss account are restate, CCA only adjust the historical operating profit with depreciation adjustment, cost of sales adjustment monetary working capital adjustment and gearing adjustment. The same principles on monetary and non-monetary items are applied here with slight difference. Holding gain or loss is calculate only on monetary working capital items and only fixed assets and inventories are restated at current values. UK SSAP 16 is known to build on CCA method

Monetary items a claim receivable or payment in a specified amount of money, regardless of changes in the purchasing power of the currency. Monetary items include assets (cash, prepaid expenses, debtor's income receivable and interest receivable) and liabilities (creditors, loans, accruals interest payable bank overdraft.

Non-monetary items any asset, liability, or shareholders' equity account that has no claim to or for a specified number of dollars. That is, if an item is not a monetary item, it must be non-monetary. They are variable in amount with regards to changes in the general prices.

WHAT OTHER PEOPLE SAY

The discussions on the limitations of historical cost accounting and the way forward has attracted comments, findings and suggestions from all angles including committees, researchers and standard setters.

Early accounting scholars such as Solomon (1986) in his book "Making Accounting Policy" argued that neither the historical cost accounting information on financial position is relevant to the enterprise at the accounting date nor the income information faithfully represents "better-offfness" of the enterprise. Due to its arbitrary allocations, its numbers are incapable of being verified by reference to events and conditions outside the enterprise. Solomon concludes that, historical cost accounting results are woefully lacking in the qualitative characteristics by which accounting information are judged.

Although historical cost accounting has been criticised by many, hoping that various inflation accounting methods may do the accounting profession some good, scholars have also raised many concerns about it.

Primer standard on inflation accounting SSAP 16 points out that CCA does not measure the effect of changes in the general value of money or translate figures into currency of purchasing power at a specific date. Therefore is not a system of accounting for general inflation. It fails to show changes in the value of the business as a whole or the market value of the equity .According to The Sandiland's Committee of UK, GPPA fails to show the company's "operating profit". It is potentially misleading in including net gains on monetary items which exist only in terms of current purchasing power units and not in terms of monetary units. Also GPPA shows how far the purchasing power of a shareholder's investment has been maintained in a sense which is not useful to him for any practical purpose. If GPPA does not provide useful information for shareholders from whose point of view it is conceived, it is unlikely to provide useful information for other users of account.

On the issue of inflation accounting Solomons(1986) reveals that, because GPPA retains historical cost as the attribute to be measured, it measures very imperfectly the amount by which an enterprise or its owners are better or worse off at the end of a period compared with the beginning. Therefore, an appearance of maintaining real financial capital may be no more than that appearance.

Hendriksen (1982) a prominent scholar in accounting theory, observes that the restatement is not intended to represent current values but merely the historical cost restated for changes in general purchasing power. However, interpretation remains difficult because historical cost represents the number of currency paid for a specific item, but restated amount does not represent the amount that would have been paid for the item if the current price-level and the current price structure were then known. And since it is not intended to be a surrogate or current value, there is a difficulty in attaching any current market or utility valuation interpretation to it. Apparently inflation accounting is does not present current values, although users may believe that the restated values correspond to current values.

Russel (1975) research on inflation accounting concludes that general price level information is not relevant and there are better ways to disclose its impact on assets and liabilities

THE QUESTIONABLE ITEMS AND TREATMENTS

Statement of profit and loss for the year ended. As the name implies, is a statement that gives account of the profit and loss a company have had within a specific period. It is written to indicate the period of reporting by saying for the period ended. According to the International Accounting Standard (IAS) 1, financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it.

The primary objective of financial statement is to represent what happen doing a period or at a particular time not what is supposed to be or will be as done under inflation accounting. Unlike statement of financial position which gives a snapshot of the company, statement of profit and loss is a video of the company which must report activities from beginning to end. Adjusting figures with indices as done in GPPA does not report the value of transaction throughout the year but rather it reports the value of transaction relative to the current market value at the end of the year. GPPA restate items using closing index that represent value at close not throughout the period. Profit and loss account as early indicated is to present activities for the whole period not at the end of the period. The restatement of items in Profit and Loss Account does not report the financial activities within the period as it supposed to be but only assume that all activities took place at end of the period. This does not fit into the definition of statement of profit and loss for the year ended.

CCA attempt to remedy this problem of GPPA by, maintaining historical figures as it should be and only adjusting with current cost adjustments. These adjustments are, cost of sales (COSA), monetary working capital (MWCA), depreciation (DA) and gearing adjustments (GA). These adjustments are the difference between the historical cost figures and current cost values of the respective items. As it will be observed in the following sections, these items also create other sets of distortions.

Both CCA and GPPA defile the primary objectives of statement of profit and loss for the year ended

Sales and expenses: Another limitation of historical cost accounting that called for inflation accounting is discrepancies in matching revenue against cost. Proposers of inflation accounting opine that, both past and current costs are match with current revenue under the historical cost, which should not be so by the matching concept. The existing inflation accounting methods especially GPPA has also failed in matching revenue against cost since revenue by its definition already adjust for inflation and even there is proper matching under the historical cost. Sales is defined as price x quantity. Price is the amount paid for which an item is sold. Theories in related subjects such as, marketing, finance and economics have proved that the traditional basis of setting price is cost-plus method. This means that the price of every product is little above its cost. The price of a product may be determined by inflation after the cost has been taken care off. The sale of a product is based on the cost of the product and inflation has less influence on it in the short term. This basic cost-plus pricing makes it more appropriate for actual cost of sales to be recorded against sales in fulfilling the matching principles. The objective of matching concept is to make sure that revenue is match against its cost and expense in producing to determine the profit or loss. Matching is rather not what GPPA does by pairing what the cost or expenses should be to revenue.

Furthermore, in pricing products marketers or producers consider inflation though not at complete level. The percentage of margin on long-term products such as cars is higher than the margin on short-term products such as water and food even when costs are same in both cases. The rationale for this basic pricing is that, price level changes on the long-run products is more than short-run products, because the short-run product can be sold quickly to recover cash than the long-run good like car.

Restating sales by inflation index on long-term goods will cause double treatment of inflation leading to overstatement of profit. Short-term goods or consumables have short market life which prices are determined by cost not inflation.

Depreciation expense

The valuation of depreciation has not been spared from the criticism on historical cost accounting. Inflation accounting methods are of the view that depreciation expense under historical cost is undervalued because it uses acquisition cost, which is past. The undervaluation of depreciation does not provide enough reserves for the replacement of the asset in current economic conditions. International accounting standard (IAS) 16 defines Depreciation as the systematic allocation of the depreciable amount of an asset over its useful life. Accounting standard 6 of India also Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined. Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value

The above definitions clearly indicate that depreciation is the charge for the use of an asset not the provision of reserves for replacement of an asset. This implies that, depreciation is an expense for spreading of asset cost over its useful life or its productivity as the case may be.

Fixed assets cost is a capital expenditure which not is written off totally at acquisition but is spread over its useful life of which benefit will be enjoy. The sharing of actual cost over its useful life known as depreciation is not provision for replacement but matching of revenue with expenditure therefore the actual acquisition cost incurred should be allocated not the inflation adjusted figure.

Depreciation provision or expense has been mistakenly taking as reserve provision for the replacement of an asset, which is just a secondary purpose. The provision of fund for replacement of assets is a sinking fund and that is not part of accounting reporting.

The replacement of assets theory of inflation accounting itself is an illusion. Literature holds that companies do not replace old assets with same assets but an improve version at different cost. This means that companies cannot meaningfully buy new assets with inflation adjusted depreciation provision. If the objective of inflation accounting is to replace asset then depreciation should be provide on the expected cost of replacing the asset which will be new asset price. Unfortunately using the new asset price does not only bring in subjectivity but divergence from the primary allocation of cost of an asset over its usage or life span. Further, such provision for depreciation for replacement of assets is not accounting reporting but sinking fund under financial management.

Inflation accounting treatment of depreciation deviates from the primary definition of depreciation to its secondary purpose of replacing assets which is not part of accounting reporting. Therefore as per existing accounting standards on depreciation, the historical accounting charge of fixed cost as expenses does not distort accounting reporting but rather inflation accounting redefines depreciation as sinking fund which is not accounting reporting.

Debtors and creditors

Basic accounting defines debtors as credit sales customers and creditors as credit purchases customers. Company hold debtors as assets and creditors as liabilities. In practice, credit sales or purchases are charged above market price resulting to element of interest. The price of substance over form says such price difference between cash sales and credit sales should be recorded as interest not part of sales. Interest is defined as, charge for risk and inflation. Which means an interest is charge to take care of inflation since payment will be receive at time when prices may have increase. A test on the relationship between inflation and interest rate has be proven to positive by many researches, thus as inflation increases, interest rate also increases. For instances interest rate is high in inflationary countries such as India, Ghana, as compared with less inflationary countries like UK, USA. An inference from this positive interest-inflation mechanism depicts that, credit sales that are charge above market price already incorporate inflation. Hence, restatement gain and loss on such debtors and creditors is an overstatement.

Consider a hypothetical case where market price of a car is Rs. 200,000. A credit sale of the same car may go for Rs. 250,000 depending on the credit period. This credit price of Rs 250,000 is forward market price at which the car will is expected to be sold at the end of the credit period. Meaning inflation has already been taken care of through the forward pricing. Inflation accounting ignores this basic principle of credit transaction and directly calculates monetary gain or loss on the credit price with the assumption that both market price and credit price are same. The same story applies in the case of credit purchases or creditors.

Inflation accounting may argue that, this price difference is just to discourage credit sales or purchases or to compensate for the risk of default but not to take care of inflation. This argument cannot be proved. Substance over form concept makes it clear that such price difference is interest and should be treated as such. Theories in economics and finance which are related subjects clearly demonstrate that business charge these prices because money will be receive at a future date which implies an account for inflation.

Since the price difference may not be able to capture the full inflation level, this paper does not completely write off the concept of monetary gain or loss on debtors and creditors but propose a practical restatement. A more pragmatic way is to deduct or add as the case may be, the price difference on credit sales or purchase on any loss or gain from restatement of debtors and creditors.

Although GPPA calculated purchasing power or loss on these items, CCA calculation of monetary gain or loss apply similar concepts creating the same problem.

Long term liabilities and investments

The question on inflation accounting of interest rate mechanism is clearer on the treatment of long-term liabilities and investments. Every long-term liability and investment assets attract interest. The discussion on interest under debtors and creditors has indicated the element of inflation in interest rate. An application of this mechanism proves that interest on loans and investments asset already consider inflation. Due to inflation component of interest, a long-term loan or investment attracts higher interest and short-term goes for lower interest rate because inflation is expected to increase in the long-term than short term.

Finance defines government bonds risk-free meaning inflation is fully adjusted in government bond rate. Therefore any rate above government bond include both risk and inflation factor. Practically, all companies' loans and investments have interest rate above government bond rate. This means interest on loans on these loans and investments already include inflation. Calculation of gain or loss on these items without considering interest causes overstatement and external inconsistency in accounting principles.

The reason for calculating gain or loss on liabilities and assets is that they are fixed in amount and company will receive or pay the same amount irrespective of the time when money will change hands. This argument is not true because company pays or receive interest in addition to intial amount. As the time increases interest also increase and the vis-a-vis is true. Therefore loan or investment is not fixed as claim under inflation accounting.

Notwithstanding the interest mechanism, inflation is not fully adjusted by interest rate hence there is need to restate loans and investment. Here also interest received or paid should be adjusted into the loss or gain.

Adjustments of interest in monetary gain or loss may seem complex but ignoring it impairs the basic true and fair presentation of financial information

Retained earnings

This is the addition of undistributed earnings over period of time. Is also known as undistributed profit or accumulated profit. The classification of retained earnings as either monetary or non-monetary items has been a matter of great concern in inflation accounting. Retained earnings is fixed in claim of amount which means that is monetary assets like cash or debtors and it should be treated as such. To the best of my knowledge there is no theory supporting the classification of retained earnings as non-monetary items. Probably is classify as non-monetary item on the basis that is part of shareholder's equity, therefore if equity is restate so as retained earning should be treated. Unfortunately, existing inflation accounting method GPPA treat retained earning as non-monetary items at balance sheet closing indices with no justification. This treatment has been acclaimed and been taught. The big question is retained earnings monetary or non-monetary? Retained earnings shares common features to monetary assets than non-monetary assets. Retained earning is fixed in amount which does not change in value with market conditions. Again retained earning holds cash hence if cash is monetary asset items should be treated same. If all transactions are on cash basis retained earnings will be cash. Retained is assumed to be in the company save without any interest for the whole period. Retained earning is also known as an idle capital like cash reserves.

The above characteristic gears retained earning towards monetary assets than non-monetary assets. Therefore existing inflation account treatment of it as non-monetary asset is inappropriate.

Treatment of retained earnings as non-monetary makes it indexed items which is not the case. GPPA restatement of retained earning with index at balance sheet date inflates the value of company without any economic basis. Finance and economic theory says that is not prudence to keep money without interest. What GPPA does, only encourage companies to keep more retained earning because restate at inflational time will increase the value of the company. Even accrual accounting which results in non-cash retained earning does not make retained earning non-monetary asset because is not traded on the market and is fixed in amount.

CCA differs from GPPA on this treatment in the sense that it maintains historical value of retained earning. Monetary gain or loss on debtors or creditors which obviously lands in retained earning brings question mark on CCA.

Equity or share capital:

Inflation accounting has the ultimate goal of reflecting financial information with current market price. The big question is why equity not reported by the stock price at the balance sheet date but equity indexed? A common man even knows that Consumer Price Index (CPI) does not affect share price. It is not unusual to say that there is no strong relationship between consumer price Index and share price. Restatement of equity by CPI index under GPPA does not represent the market price of the shares. For instance preparation of company which has near zero share prices under inflation accounting will show high equity value which does not reflect the true value of the stock. If the market value of equity is different from the inflation adjusted accounting, what importance is it to investors? Inflation adjusted equity deceive investors. Investors are interested in how much they can sell or buy shares which is fully price by the stock exchange market not indexed values. To mark share price to market values as inflation accounting posit to be, stock exchange market prices should be used as the current price.

RECOMMENDATIONS

This paper appreciates the attempts by existing inflation accounting methods in arresting the historical accounting limitations and it recommends the following measures to improve it.

- Statement of profit and loss should be recorded at acquisition cost since it is a report on the activities for a given period.
- As per current accounting standards depreciation is a charge for the use of an asset hence it should be apply as such not as a sinking fund for replacement. This means depreciation should be recorded at historical cost.
- Credit sales and purchases which are charge at above market price must not be adjusted since inflation has already been considered by the price difference. Adjustment can be done if the price difference does not fully incorporate inflation rate. With such situation the price difference should be added or deducted from the loss or gain as the case may be.
- Retained earnings should be treated as monetary assets because is fixed in claim irrespective of price level changes.
- Debentures, long term loans and investments attract interest which takes care of inflation, therefore monetary gain or loss should not be calculated on them. Here also, if interest fails to incorporate inflation fully, then monetary gain or loss so calculate should be adjusted with the interest receive or paid.
- Equity or share capital must be recorded at the closing price of the company shares as at the last date of reporting because is the true market value of the company at that time.
- Fixed assets in balance sheet should be restated at fair values in consideration of its usage and age.
- Whilst, the paper welcomes fair value accounting, it admits its limitation of been idealist and subjective measures but is better than existing CCA and GPPA. Only fixed asset should be fair value at the balance sheet date.

Conclusion

There is no doubt that historical cost accounting has limitations, as there is nothing under the sun which is free from inadequacy. But its limitation is blown out of proportion. The solution to these limitations is not existing accounting for price changes for it gives more questions than answers. Apart from the traditional known limitations such as subjectivity and complex couple with unrealistic profit, this paper has demonstrated other major limitations behind inflation adjusted figures.

A microscopic view at inflation adjusted reporting as it has been done by this paper indicates both internal and external inconsistency of accounting principles. Economics and finance define interest is a combination of risk and inflation. Therefore any asset or liability that attracts interest has already incorporated inflation. Hence an adjustment for inflation on these assets and liabilities resolve in double treatment of inflation which distorts the basic concepts of objectivity and realisation.

Another fascinating issue about inflation accounting is, it posits itself as asset replacement or capital maintenance method been it financial or physical. In practice inflation accounting creates illusionary or imaginary profit which does not exist, thus capital maintenance concept is just a paper theory because much of the profit under inflation accounting is unrealised or holding gain. Retaining part of the profit has been a historical concept of fulfilling the basic going-concern principle. In order for a business to run for the foreseeable future, it must set aside part of profits which is called retained earnings for expansion or replacement.

What will company do with its retained earnings if not replacement and expansion? Therefore capital maintenance is not a new concept by inflation accounting, company have been maintaining capital and asset under the historical cost by retaining some of the profit.

Historical cost accounting may lack behind current economic conditions, it provides realistic profit for maintaining capital through retained earnings.

It is therefore increasing necessary that accounting academicians and professionals take a critical look at the whole accounting system from the primary responsibility of reporting to the interpretation of the accounts in the implementation of inflation accounting. From history to date, accounting principles and standards have been on the pillars of historical cost accounting, hence any new method requires a revolutionary change not just a single standard.

The greatest deterrent to adoption of price level changes accounting is what it is not: inflation accounting is not present value, net realizable value, or current market values or fair value and therein lies much of the opposition to its use

My final question to inflation accounting is, has any company collapse or not able to maintain capital because of historical cost accounting reporting? A thoughtful answer to this question will open new research gate into inflation accounting.

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