17.11. Mr. Gopal
thanks
23/11

ECONOMIC TIMES dt. 7.9.83

INFLATION ACCOUNTING

By R. Gopal

Over the years (especially since 75), there has been unprecedented lationary pressure on the Indian onomy. This has resulted in an erage increase in the price index more than 5-10 per cent p.a. less this increase in the inflation e is controlled there is very little ance of survival. The need of roducing inflation accounting is lt because in a changing infla- onary situation (a) a realistic picture of the cor- rate profitability and growth is ailable; b) it can ensure that the rporations maintain their operat- g capability without affecting areholders' interest and (c) it can ovide a realistic basis for mana- ment decisions with regard to) appropriation of profit and loss count, (ii) gearing ratio, (iii) ex- nsion, (iv) pricing, etc. measuring productivity

Inflation accounting also offers insight to the management; out the extent to which the repla- ment needs of the various assets ve been understated through de- eciation based on conventional ac- unting and, as a natural conse- ence, the overstatement of profits. rther, in case of merger or pos- sible take-over by the government, revalued assets provide a better and more correct perspective regard- ing the true worth of assets. Infla- tion accounting also helps in getting the assets insured on a reinstatement basis.

There are basically two aspects to the question of inflation accounting: (a) How to compute the impact of inflation accounting and (b) how to incorporate the effect of inflation accounting.

Different methods are available for revaluating the assets. Some of these are:

(a) use of consumer|machinery price|industry indices; (b) techno- economic revaluation of the assets based on the market value of the asset after providing for obsoles- cence, number of years of service repair and maintenance of the asset etc.; (c) the earning potential value of the asset(s) based on the pre- sent value of all future cash streams which the asset is expected to rea- lise; (d) the realisable value of the asset in case of a 'forced sale'; (e) the value of the asset in case it is put to alternate uses, and (f) the value of the asset to the owner itself.

Each of the methods has its own advantages|disadvantages. For exam- ple, the consumer price index|ma- chinery price index|industry price index depends inter alia on the basket of commodities|machineries ta- ken into consideration (the base year considered etc.) while the value of the asset based on market value would depend on factors like the source of supply, the estimation of when the asset would become obso- lete, etc. Further, the realisable va- lue of the asset in case of a 'for- ced sale' may not represent the 'true and fair' value due to inherent factors present in such a sale. How- ever, considering various factors like practicability of the method, etc., it appears that: (a) replacement value of the asset method and (b) earn- ing potential method are the only two important ones. The net value of the asset would then be the low- er of these two measures.

To incorporate the effect of infla- tion accounting, certain major ad- justments will have to be carried out to the historical profit and loss statements. These adjustments are:

Depreciation adjustments: This is done so as to register the impact of price changes when determining the charge on revenue for consumption of fixed assets.

Cost of sales adjustment: This allows for the impact of price changes when determining the charge against revenue for stock consumed during the period. It is basically the difference between the market value of the stock and the cost of stock as calculated on the historical cost basis.

Working capital adjustment: This adjustment is done for current as- sets and current laibilities (other than stocks), for e.g., debtors, cre- ditors, etc. Thus when sales are made on credit, the business has to finance the price escalation till cre- dit sales result into cash. On the other hand, when materials and ser- vices are purchased from suppliers, the effect of price changes are taken over by the supplier of the mate- rials and services.

Gearing adjustments: This adjust- ment is done because part of the net operating assets is financed by borrowings which are to be repaid in the same monetary amount ir- respective of changes in price levels.

In the US and the UK the deve- lopment and implementation of in- flation accounting techniques can be considered to b fairly well advan- ced. In the US, the financial ac- counting standards Board has pub- lished a document entitled FAS33 on inflation accounting. FAS33 ap- plies to publicly held companies, in- cluding financial companies with a total assets of more than $1 billion. The FAS33 requires that both the historical costs as well as current cost methods be presented.

In the UK, after the Sandilands Committee Report (in 1974) seve- ral exposure drafts have been pub- lished to date. The exposure draft (ED 24) has explicity recommended current cost accounting standard as the most appropriate adjustment to the historical cost accounting me- thod. As a result of this the state- ment of standard accounting practice No. 16 (SAP 16) has been put into effect. The SSAP 16 sets out a current cost accounting system which is based on a concept of ca- pital represented by net fixed assets stated at current cost. In the UK it is mandatory to include inflation accounting for all companies except insurance and property companies. In South America, countries like Brazil, Chile, Peru, Uruguay and in most of the other European coun- tries periodic revaluation of capital is carried out. In some Latin Ame- rican countries, official indices for carrying out revaluation are pro- vided by a government agency. The additional depreciation obtained is also deductible for tax purposes.

In India, revaluation of assets is not mandatory. However, the govern- ment is aware of the impact of ing costs in replacing the ass Further, there are no accepta price indices for revaluation of sets as in other countries. Howe some companies do revalue th assets periodically and incorpor the same in the annual report. N table among them are the Bi companies like Hindalco, Gwal Rayon, etc. Recently, TISCO, T Chemicals, etc., have also start incorporating inflation accounting their annual reports.

Almost all multinational comp nies in India maintain two sets accounts (a) based on historic costs for the local shareholders a (b) based on current costs for th principals.

In view of the above, it is f that it is high time that in In too presentation of accounts on t basis of inflation accounting is ma mandalory because they not or help the management present t operational conditions in a bett and more realistic manner to t government, but also help the m nagement to take steps before indu trial sickness could creep in. Howev a word of caution must be mention at this stage regarding the applic bility of MRTP laws on the basis inflation accounting.