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Accounting and Reporting of Effects of Changing Prices with Special Reference to KSFCI, Bangalore

Management

KEYWORDS : Inflation Accounting, Price Level Changes, Profitability of the Company

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ABSTRACT

The existing accounting practice of preparing financial statements are based on an important accounting assumption, namely, the monetary postulate, which states that the value of the monetary unit is stable and that fluctuations in it may be ignored in the preparation of accounts. So long as prices and costs remain stable, no accounting problem arises. But with the movement – upwards or downwards – in the price – level, the assumption of a stable monetary unit does not hold good. Consequently, a host of problems begin to creep into the accounts. This study shows although inflation effects are not recognized in nominal financial statements, they have significant economic consequences even during a period in which inflation is relatively low. This study also shows that how the inflation has affected the profitability of KSFCI, Bangalore.

INTRODUCTION

In economics, inflation is a rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation also reflects erosion in the purchasing power of money – a loss of real value in the internal medium of exchange and unit of account within the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the Consumer Price Index) over time.

OBJECTIVES OF THE STUDY

1. To explain the distortions in accounting results during the period of changing prices.
2. To List the different proposals for dealing with the problem of inflation in accounts.
3. To explain the adjustments that is to be made in the profit and loss statement and the balance sheet in the General Purchasing Power Accounting (GPPA).

RESEARCH METHODOLOGY

To study the impact of inflation accounting on the profitability of the company the theoretical framework has been studied in application with KSFIC. This study is a descriptive study where the current cost accounting method for evaluating the profitability is adopted for the company.

LITERATURE REVIEW

A study conducted by ***Cenap Ilter*** on **Exploring the Effects of Inflation Accounting on Financial Statement** explores the effects of inflation on financial statement. Inflation, even at lower rates affects financial statements. This criteria-an inflation rate for restatement of financial statements can be set as minimum as possible, because inflation adjustments change the figures even at lower inflation rate. As the inflation accelerates the effects of inflation become more apparent on financial statements. Based on the study the management is advised to watch the inflation and calculate the possible effects of it on the financials.

The study on **Forecasting Inflation** by ***Jon Faust and Jonathan H. Wright*** states that long – term nominal commitments such as labor contracts, mortgages and other debt, and price stickiness are widespread features of modern economies. In such a world, forecasting how the general price level will evolve over the life of a commitment is an essential part of private sector decision-making. The existence of long-term nominal obligations is also among the primary reasons economists generally believe that monetary policy is not neutral, at least over moderate horizons.

As per the literature review it is clear that there are various distortions in the financial report because of inflation accounting. So our study concentrates on the distortions and also how the profitability of KSFIC is affected by the inflation accounting.

DISTORTIONS IN ACCOUNTING RESULTS

The monetary postulate underlying historical cost accounting does not hold good during the period of changing prices. Consequently, a host of problems begin to creep into the accounts with the movement in prices. Such problems have the effect of distorting the accounting results in various ways like Non – recovery of costs, Problem of replacement, financial strain on Business, Problem of Capital Levy and Capital Distribution and so on.

FINDINGS

Based on the theoretical background of the demerits of the historical approach a study has been conducted on KSFIC to know the effect of inflation on profits of the said company. For the study purpose previous year balance sheet (i.e. 2011-2012) has been taken and Current Purchasing Power Method is considered.

Table 1: Actual and Inflated profit and loss account of KSFCI for 2012

Particulars	Actual Expenditure	Inflated Expenditure
Purchases	42320369	43422489.65
Raw materials	51940537	53293155.15
Operatives & other expenses	113665837	116625884.8
Employees remuneration & other benefits	64368395	66044655.29
Administration Selling & expenses	--------	--------
Depreciation	2140636	2196381.73
TOTAL	274435774	281582566.6

Source: Annual Reports of KSFIC for the year 2011-12

Interpretation: From the above table we can conclude that the actual expenses are very low when compared to that of the inflated ones. This is because the value of money which is assumed to be constant is not so. So for all the expenses the current value is more when compared to the expenditure when they were made.

One more table which is shown below shows the profit figures which are based on actual expenses as well as inflated expenses which are calculated on the basis of wholesale price index:

Table 2: Profit figures based on actual expenses in comparison with inflated expenses

Particulars	Actual	Inflated
Revenue	281517049	281517049
Total Expenditure	274435774	281582566.6
Profit (Loss)	7081275	-65517.6

Source: Annual Reports of KSFIC for the year 2011-12

Interpretation: From the above table we can observe that the profit which is shown on historical cost accounting is more when compared to that of the profits when it is calculated on the basis of inflation accounting.

The formula which is used to calculate the inflation expenses is as mentioned below:

$$\text{Purchases} = \frac{\text{Expenses Index at the end of the year}}{\text{Expenses Index at the begging of the year}}$$

This is the status of the profit and Loss account. This is also applicable even for the balance sheet items. Let us see how the current purchasing power method of inflation affects the balance sheet figures.

While calculating the inflation effects on balance sheet items we have to calculate the loss on monetary assets and gain on monetary liabilities. Finally we have to calculate the net monetary gain or loss from these monetary assets and liabilities.

The index which is used to convert the historical value into the current value is wholesale price index.

That is on 31/3/2011 the WPI was 148.1 and on 31/3/2012 the WPI was 158.4

Table 3: net monetary result on account of price level changes

Monetary Liabilities:		
Monetary liabilities as on 31/3/2011 (102945707 X 1.07)	110151906	
Increase in monetary liability during the year (9143700 X 1.07)	9783759	
Inflated value of the monetary liability	119935665	7846258
Historical value of the monetary liability as on 31/3/2012	112089407	
Monetary Assets:		
Monetary Assets as on 31/3/2011 (224837267 X 1.07)	240575876	
Increase in monetary asset during the year (18082066 X 1.07)	19347811	
Inflated value of the monetary asset	259923687	
Historical value of the monetary asset as on 31/3/2012	242919333	**(17004354)**
Net loss on monetary assets		(9158096)

Source: Annual Reports of KSFIC for the year 2011 – 12.

***Profit and Loss Account*:** Table 1 shows all the items of profit and loss account. The amount which we can observe is mentioned both in the historical cost accounting as well as current purchasing power method. As per the study it is clear that all the expenses i.e., purchases, raw materials, operatives, employee remuneration, administration and selling expenses and depreciation is less when compared to that of inflated values which leads to lesser profits.

Profit figures: Table 2 shows the inflated and the actual profits are varying to a greater extent. As per the historical method there is a profit. But as we go through the inflation accounting method there is a loss.

Net Monetary Gain or Loss on Holding the Assets and Liabilities: Table 3 depicts the calculation of Monetary Gain and Loss for the previous year 2011 – 12. By holding the monetary assets the company is going for the loss. But the company will gain through holding the monetary liabilities. The monetary loss is greater than that of the monetary gain for the KSFIC in the previous year. This is the effect of inflation.

CONCLUSION

From the study it is clear that the profit figures will vary to a greater extent because of changing price levels. And it will be causing various problems for the true financial position as it has been discussed earlier. In the study the current purchasing power method is used to analyse the data which is not free from various drawbacks. Those demerits are as mentioned below;

1. An important weakness of this method is its concern about changes in the general level of prices as opposed to those in the specific prices.
2. The purchasing power unit proposed by the GPPA method is not easily perceived by the users of financial statements. Whereas a monetary unit is easily understood and perceived.
3. It is maintained that the purchasing gain/losses arising due to price-level changes which are recognized by the GPPA method, are likely to get confused with operating profits of the enterprise. This is likely to obscure the results of managerial skills and decisions.
4. The amount of work and costs involved in the reproduction of price – level adjusted accounts is so large that smaller companies may not opt for such reproduction of accounts.

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