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ACCOUNTING FOR PRICE LEVEL CHANGES: PROSPECTS AND PROBLEMS

Otemu Eseoghene

Department of Accountancy

Delta State Polytechnic Otefe

Otemu Oghenevwogaga

Department Of Banking and Finance

Delta State Polytechnic Otefe

ABSTRACT: *Prices do not remain constant over a period of time. They tend to change due to various economic, social or political factors. Changes in the price levels cause two types of economic conditions, inflation and deflation. Inflation may be defined as a period of general increase in the prices of factors of production whereas deflation may fall in the general price level. These changes in the price levels lead to inaccurate presentation of financial statements which otherwise are prepared to present a true and fair view of the company's financial health. This is so because the financial statements are prepared on historical costs on the assumption that the unit of account. Accounting for price level changes is a system of maintaining accounts in which all items in financial statements are recorded at current values. This system of accounting ascertains profit or loss and presents financial position of the business on the basis of current prices. Accounting for price level changes is also called inflation accounting.*

KEYWORDS: Prices, Price level changes, Inflation, Deflation, Equity.

INTRODUCTION

Accounting for price-level changes also referred to as inflation accounting is a financial reporting procedure which records the consequences of inflation on the financial statements that a company prepares and publishes at the end of the financial year, which is based on the assumption of a stable currency. The 1970s and 1980s were exciting period for accountants who welcomed change. The extremely high rates of inflation that were a feature of the period posed a considerable challenge to the traditional historically based financial accounting model. Within a period of less than twenty years, the professional accountancy bodies turned from conservative advocates of the historical cost status quo to radical reformers, urging the introduction of new systems and ideas. As the dragon of inflation was tamed, the urge for radical change dimmed, but reform did not come to an end. The challenge to the conventional wisdom that historical cost accounts were all one needed did not go away. The theoretical debate about the nature and purposes of financial accounting that accompanied attempts to take account of changing prices and the discussions about the merits of different models of measurement continued, to a large measure, in the area of standard setting. While the attempt to introduce a new orthodoxy based on the adoption of a system of financial accounting that comprehensively and systematically takes account of changing prices, general, specific or both, was halted via the withdrawal by the Financial Accounting Standards Board (FASB) of its standard on Accounting For Price Level Changes. Ball and Brown (2008) has the opinion that

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Financial accounting information in periods of rising prices has been criticized on the grounds that it reflects a number of dated monetary units while the value of the monetary unit is changing.

According to Hughes, Liu, and Zhang (2004), inflation creates earnings illusion as an artifact of the mismatching of expenses based on allocations of historical costs with current revenues in determining earnings. This mismatching distorts mappings of aggregate earnings and book values into equity value such that value-relevant information is lost.

In a period of general inflation, the relevance of historical costs is brought into question because they do not reflect consistently the current financial position or recent performance of the firm. In so far as historical costs are established at different dates, when the currency unit represented different real purchasing power, it can be argued that accounts drawn up on this basis create the fundamental measurement error of aggregating heterogeneous measurement units and thus, such financial statements are not value relevant in making informed decisions by various users of accounting information. Therefore, there is a need to restate the financial statements to capture the prevailing the economic realities in the firms to disclose the current performances and positions of the firms in concomitant with the dynamics of the measuring unit. This forms the nexus between financial accounting measurement and price- level changes.

Baskin, (2011) note that relevance of accounting information have focused on historical accounting data in estimating share price movement. To the best our knowledge, no study has adjusted the historical data for price level changes to determine if a significant relationship exists between historical accounting estimates and inflation-adjusted accounting estimates in share price determination. It is against this backdrop that this study attempts to carry out a comparative analysis of the value relevance of accounting information to ascertain if the priori expectation that inflation-adjusted financial statements approximate more accurately the market realities holds true.

Beaver, (2008) says that conventional or historical cost accounting assumes that money has stable value. But in reality, value of money varies from time to time as a result of changes in the general level of prices. Prices of goods and services change over the time. The change in price as a result of various economic and social forces brings about a change in the purchasing power of money.

"Inflation is the most important fact of our time, the single greatest peril to our economic health". Prices of various goods and services have been rising at an alarming rate- "Though the history of mankind is a history of rising prices, inflation has become a worldwide phenomena since the second world war. In a country like India the problem is more acute with its developing economy". Governments ever rising administrative expenditure, enlarging plan outlays without corresponding increase in productivity and various types of subsidies have given an impetus to inflation. Each one of us experience the impact of inflation in everyday life. Neither can we wish away inflation nor can we remain insensitive spectators. Problems associated with inflation must be brought in to sharp focus to understand their magnitude.

Objectives of the paper

i. To examine the concept of accounting for price level changes

ii. To examine the causes of price level changes

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iii. To examine the effect of Redistribution of Income and Wealth

LITERATURE REVIEW

Meaning of accounting for price level changes

The general tendency in changes of prices of goods and services over a time is called price level. The rise in general price level is called inflation. During the period of inflation, purchasing power of money declines. The fall in the general price level is called deflation. During the period of deflation, purchasing power of money increases. Price level change means increase or decrease in the purchasing power of money over a period of time. The accounting which considers price level changes is called accounting for price level changes.

According to Collins, (1997) Accounting for price level changes is a system of maintaining accounts in which all items in financial statements are recorded at current values. This system of accounting ascertains profit or loss and presents financial position of the business on the basis of current prices. Accounting for price level changes is also called inflation accounting.

Types of accounting price level changes

i. **Current Purchasing Power**: Current Purchasing Power of accounting requires the companies to keep their records and present the financial statements on conventional historical cost basis but it further requires presentation of supplementary statements in items of current purchasing power of currency at the end of the accounting period.

   In this type of accounting price level, Desai (2005) discuss the various items of financial statements, i.e. balance sheet and profit and loss account are adjusted with the help of recognized general price index. The consumer price index or the wholesale price index prepared by the Reserve Bank of India can be taken for conversion of historical costs.

   The main objective is to take into consideration the changes in the value of money as a result of changes in the general price levels. It helps in presenting the financial statements in terms of a unit of measurement of constant value when both cost and revenue have been changing due to changes in the price levels.

ii. **Replacement Cost Accounting** Replacement Cost Accounting (RCA) is an improvement over Current Purchasing Power Technique (CPP). One of the major weaknesses of Current Purchasing Power technique is that it does not take into account the individual price index related to the particular assets of a company.

   Easton et al (1991) have the view that Replacement Cost Accounting, the index used are those directly relevant to the company's particular assets and not the general price index. In this sense the replacement cost accounting technique is considered to be a improvement over current purchasing power. But adopting the replacement cost accounting technique will mean using a number of price indices for conversion of financial statements and it may be very difficult to find out the relevant price index to be used in a particular case. Further, the replacement cost accounting technique provides for an element of subjectivity and on this ground it has been criticized by various thinkers.

iii. **Current Value Accounting**: In the Current Value Accounting of price level accounting all assets and liabilities are shown in the balance sheet at their current values.

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The value of the net assets at the beginning and at the end of the accounting period is ascertained and the difference in the value in the beginning and the end is termed as profit or loss, as the case may be. In this method also, like replacement cost accounting technique, it is very difficult to determine relevant current values and there is an element of subjectivity in this technique.

iv. **Current Cost Accounting:** The crux of the current cost accounting technique is the preparation of financial statements (Balance Sheet and Profit and Loss Account) on the current values of individual items and not on the historical or original cost.

The essential characteristics of current cost accounting technique are as follows:

1. The fixed assets are shown in the balance sheet at their current values and not on historical costs.
2. The depreciation is charged on the current values of the fixed assets and not on original costs.
3. Inventories or stocks are valued in the balance sheet at their current replacement costs on the date of the balance sheet and not cost or market price whichever is lower.
4. The cost of goods sold is calculated on the basis of their replacement cost to the business and not on their original cost.
5. The surpluses arising out of revaluation are transferred to Revaluation Reserve Account and are not available for distribution as dividend to the shareholders.
6. In addition to the balance sheet and profit and loss account, an appropriation account and a statement of changes is prepared.

The current cost accounting (CCA) has been preferred to the current purchasing power (CPP) of price level accounting as it is a complete system of inflation accounting. The financial statements prepared under this technique provide more realistic information and make a distinction between profits earned from business operations and the gains arising from changes in price levels.

Causes of accounting price level changes

One of the causes of accounting price level changes in Nigeria has been the various government polices to stimulate a past rate of economic growth and development since independence. In recent years, however, specific policies like struCtural Adjustment Programme (SAP), external debt policies, second tier foreign exchange market policies, policies on subsidized on petroleum products and fertilizers policies of privatization and commercialization, policies on trade, liberalization and interest rate deregulation and other are responsible for the inflationary trend in our economy.

Before SAP, accounting price level changes also know as inflation in Nigeria was by primary rising the world export price and falling output. These are the major external factor contributing to Nigeria’s inflation. Thereafter, domestic or internal causes like increase government expenditures, raising domestic credit creation and supply, bottlenecks such as shortage of raw

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materials and spare parts worsened the situation. There is need therefore for monetary policy reform exchange rate reform, effective inflation in Nigeria.

According to Okowa (1996), inflation is a problem that afflicts all economics. But that, it is typically more severe in the less developed countries.

Many conditions have made inflation possible in Nigeria, thus, several factors are identified as being responsible for inflation and its rising rate in Nigeria. Okowa (1996) attributes inflation to structural rigidities and supply inelasticity. He also mentions fiscal and monetary responsibility as what increases inflation. Given that inflation could occur as a result of the actions of consumers, producers or workers. Akpakpan (1994) argues that the root causes of the problem are found beyond the actions of the mentioned economic agents. He posits the necessity of examine the factors that determine, induce or permit such actions. Akpakpan attributes inflation to two related factors that are responsible for the actions of economic agents,

1. The way Nigeria organizes and conducts the production and exchange of goods and services in the country.

2. The policies Nigeria uses to sustain her chosen system of production.

The factors condition each other. Beyond creating conditions for selfish manipulations, a system of production that is characterized by private ownership and market direction of activities induced government policies and policy measures or instruments which intensify the problem of inflation in the society.

Akpakpan goes ahead to state that fixed policy has been abused in Nigeria and that the problem in a consequence of this as well as the fact that the economy is managed by dishonesty people.

Gbosi (1993) argues that the phenomenon of inflation in Nigeria is caused by the following:-

1. Rapid structural changes in the economy in recent years, the oil that increases money supply.

2. Rapid urbanization which intensifies the demand for goods and services that is in relatively short.

3. Expansionary monetary policy adopted by the central bank of Nigeria.

From an industrial point of view, Okowa (1995) attributes inflations to:

1. Corruption mediated a decrease in effective labour inputs.

2. Indiscipline which gives rise to a reduction of effective labour input, this would yield a decline in supply.

3. Corruptions which mediate a decrease in capital stock, which will bring about the problem.

Consequently, civil war ravage Nigeria for thirty (30) months between July 1966 and January 1970, inflation showed itself then, but it was glaring and serious by the middle of 1969 to May 1970. In some cases prices of locally made goods rose to about 200%. The price of a tin of peak milk rose from 6k early in 1966 to 16k in some places in March 1970. Money was not worth much because only few goods were available to be purchased with money.

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This phenomenon was caused by the federal government determination to finance the war with its own resources. Consequently, banks gave more credit facilities to public agencies, which engaged in the unproductive activities of the war.

The government without the corresponding production of goods and services spent more money. Another case or rather what aggravated the situation was due to the ineffective fiscal measure aimed at withdrawing of money in circulation via the 5% national recommendation and development saving scheme launch in January 1968 and partly tot eh activities of the smugglers.

To extend it further, the government appoints a price control board on rational level with its branches in all the states of the federation to peg the prices of the certain essential consumer goods like milk and drinks on the one hand and building materials on the other hand. For example, a bag of cement, was sold N1.35 in March 1969 was sold for N2.70 in March 1970. We shall now examine the general effects of price control and it's effectives or not. We shall use cement again, which has always been controversial. Before July 20, 1970 a bay of cement was sold for N1.50 at Ibadan. On that was the ceiling price. The board said" each price represents a ceiling which trades must not exceed if any trader wants to increase his share of the market and offer a lower price than the recommended fixed price, he is free to sell at that reduced price.

The effects of price level changes

Some of the major effects of accounting price level changes also known as inflation are as follows:

1. Effects on Redistribution of Income and Wealth
2. Effects on Production
3. Other Effects

Inflation affects different people differently. This is because of the fall in the value of money. When price rises or the value of money falls, some groups of the society gain, some lose and some stand in-between. Broadly speaking, there are two economic groups in every society, the fixed income group and the flexible income group.

People belonging to the first group lose and those belonging to the second group gain. The reason is that the price movements in the case of different goods, services, assets, etc. are not uniform. When there is inflation, most prices are rising, but the rates of increase of individual prices differ much. Prices of some goods and services rise faster, of others slowly and of still others remain unchanged. We discuss below the effects of inflation on redistribution of income and wealth, production, and on the society as a whole.

Effects on redistribution of income and wealth

There are two ways to measure the effects of inflation on the redistribution of income and wealth in a society. Gitman, (2004) discuss that, on the basis of the change in the real value of such factor incomes as wages, salaries, rents, interest, dividends and profits. Second, on the basis of the size distribution of income over time as a result of inflation, i.e. whether the incomes of the rich have increased and that of the middle and poor classes have declined with

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inflation. Inflation brings about shifts in the distribution of real income from those whose money incomes are relatively inflexible to those whose money incomes are relatively flexible.

The poor and middle classes suffer because their wages and salaries are more or less fixed but the prices of commodities continue to rise. They become more impoverished. On the other hand, businessmen, industrialists, traders, real estate holders, speculators, and others with variable incomes gain during rising prices.

The latter category of persons becomes rich at the cost of the former group. There is unjustified transfer of income and wealth from the poor to the rich. As a result, the rich roll in wealth and indulge in conspicuous consumption, while the poor and middle classes live in abject misery and poverty.

But which income group of society gains or losses from inflation depends on who anticipates inflation and who does not. Those who correctly anticipate inflation, they can adjust their present earnings, buying, borrowing, and lending activities against the loss of income and wealth due to inflation.

They, therefore, do not get hurt by the inflation. Failure to anticipate inflation correctly leads to redistribution of income and wealth. In practice, all persons are unable to anticipate and predict the rate of inflation correctly so that they cannot adjust their economic behaviour accordingly. As a result, some persons gain while others lose. The net result is redistribution of income and wealth.

The effects of inflation on different groups of society are discussed below:

(a) **Debtors and Creditors:** During periods of rising prices, debtors gain and creditors lose. When prices rise, the value of money falls. Though debtors return the same amount of money, but they pay less in terms of goods and services. This is because the value of money is less than when they borrowed the money. Thus the burden of the debt is reduced and debtors gain.

On the other hand, creditors lose. Although they get back the same amount of money which they lent, they receive less in real terms because the value of money falls. Thus inflation brings about a redistribution of real wealth in favour of debtors at the cost of creditors.

(b) **Salaried Persons:** Salaried workers such as clerks, teachers, and other white collar persons lose when there is inflation. The reason is that their salaries are slow to adjust when prices are rising.

(c) **Wage Earners**: Wage earners may gain or lose depending upon the speed with which their wages adjust to rising prices. If their unions are strong, they may get their wages linked to the cost of living index. In this way, they may be able to protect themselves from the bad effects of inflation.

But the problem is that there is often a time lag between the raising of wages by employees and the rise in prices. So workers lose because by the time wages are raised, the cost of living index may have increased further. But where the unions have entered into contractual wages for a fixed period, the workers lose when prices continue to rise during the period of contract. On the whole, the wage earners are in the same position as the white collar persons.

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(d) **Fixed Income Group**: The recipients of transfer payments such as pensions, unemployment insurance, social security, etc. and recipients of interest and rent live on fixed incomes. Pensioners get fixed pensions. Similarly the rentier class consisting of interest and rent receivers get fixed payments.

The same is the case with the holders of fixed interest bearing securities, debentures and deposits. All such persons lose because they receive fixed payments, while the value of money continues to fall with rising prices.

Among these groups, the recipients of transfer payments belong to the lower income group and the rentier class to the upper income group. Inflation redistributes income from these two groups toward the middle income group comprising traders and businessmen.

(e) **Equity Holders or Investors:** Persons who hold shares or stocks of companies gain during inflation. For when prices are rising, business activities expand which increase profits of companies. As profits increase, dividends on equities also increase at a faster rate than prices. But those who invest in debentures, securities, bonds, etc. which carry a fixed interest rate lose during inflation because they receive a fixed sum while the purchasing power is falling.

(f) **Businessmen:** Businessmen of all types, such as producers, traders and real estate holders gain during periods of rising prices. Take producers first. When prices are rising, the value of their inventories (goods in stock) rise in the same proportion. So they profit more when they sell their stored commodities.

The same is the case with traders in the short run. But producers profit more in another way. Their costs do not rise to the extent of the rise in the prices of their goods. This is because prices of raw materials and other inputs and wages do not rise immediately to the level of the price rise. The holders of real estate's also profit during inflation because the prices of landed property increase much faster than the general price level.

(g) **Agriculturists:** Agriculturists are of three types, landlords, peasant proprietors, and landless agricultural workers. Landlords lose during rising prices because they get fixed rents. But peasant proprietors who own and cultivate their farms gain. Prices of farm products increase more than the cost of production. For prices of inputs and land revenue do not rise to the same extent as the rise in the prices of farm products. On the other hand, the landless agricultural workers are hit hard by rising prices. Their wages are not raised by the farm owners, because trade unionism is absent among them. But the prices of consumer goods rise rapidly. So landless agricultural workers are losers.

(h) **Government:** The government as a debtor gains at the expense of households who are its principal creditors. This is because interest rates on government bonds are fixed and are not raised to offset expected rise in prices. The government, in turn, levies less taxes to service and retire its debt.

With inflation, even the real value of taxes is reduced. Thus redistribution of wealth in favour of the government accrues as a benefit to the tax-payers. Since the tax-payers of the government are high-income groups, they are also the creditors of the government because it is they who hold government bonds.

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As creditors, the real value of their assets decline and as tax-payers, the real value of their liabilities also declines during inflation. The extent to which they will be gainers or losers on the whole is a very complicated calculation.

Effects on production

When prices start rising production is encouraged. Producers earn wind-fall profits in the future. They invest more in anticipation of higher profits in the future. This tends to increase employment, production and income. But this is only possible up to the full employment level. Further increase in investment beyond this level will lead to severe inflationary pressures within the economy because prices rise more than production as the resources are fully employed. So inflation adversely affects production after the level of full employment. (Hughes, 2004)

The adverse effects of inflation on production are discussed below:

(a) **Misallocation of Resources**: Inflation causes misallocation of resources when producers divert resources from the production of essential to non-essential goods from which they expect higher profits.

(b) **Changes in the System of Transactions:** Inflation leads to changes in transactions pattern of producers. They hold a smaller stock of real money holdings against unexpected contingencies than before. They devote more time and attention to converting money into inventories or other financial or real assets. It means that time and energy are diverted from the production of goods and services and some resources are used wastefully.

(c) **Reduction in Production:** Inflation adversely affects the volume of production because the expectation of rising prices along-with rising costs of inputs bring uncertainty. This reduces production.

(d) **Fall in Quality**: Continuous rise in prices creates a seller's market. In such a situation, producers produce and sell sub-standard commodities in order to earn higher profits. They also indulge in adulteration of commodities.

(e) **Hoarding and Black marketing:** To profit more from rising prices, producers hoard stocks of their commodities. Consequently, an artificial scarcity of commodities is created in the market. Then the producers sell their products in the black market which increases inflationary pressures.

(f) **Reduction in Saving:** When prices rise rapidly, the propensity to save declines because more money is needed to buy goods and services than before. Reduced saving adversely affects investment and capital formation. As a result, production is hindered.

(g) **Hinders Foreign Capital**: Inflation hinders the inflow of foreign capital because the rising costs of materials and other inputs make foreign investment less profitable.

(h) **Encourages Speculation:** Rapidly rising prices create uncertainty among producers who indulge in speculative activities in order to make quick profits. Instead of engaging themselves in productive activities, they speculate in various types of raw materials required in production.

Other effects

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Inflation leads to a number of other effects which are discussed as under:

(a) **Government**: Inflation affects the government in various ways. It helps the government in financing its activities through inflationary finance. As the money incomes of the people increase, government collects that in the form of taxes on incomes and commodities. So the revenues of the government increase during rising prices.

Moreover, the real burden of the public debt decreases when prices are rising. But the government expenses also increase with rising production costs of public projects and enterprises and increase in administrative expenses as prices and wages rise. On the whole, the government gains under inflation because rising wages and profits spread an illusion of prosperity within the country.

(b) **Balance of Payments:** Inflation involves the sacrificing of the advantages of international specialisation and division of labour. It affects adversely the balance of payments of a country. When prices rise more rapidly in the home country than in foreign countries, domestic products become costlier compared to foreign products.

This tends to increase imports and reduce exports, thereby making the balance of payments unfavourable for the country. This happens only when the country follows a fixed exchange rate policy. But there is no adverse impact on the balance of payments if the country is on the flexible exchange rate system.

(c) **Exchange Rate**: When prices rise more rapidly in the home country than in foreign countries, it lowers the exchange rate in relation to foreign currencies.

(d) **Collapse of the Monetary System**: If hyperinflation persists and the value of money continues to fall many times in a day, it ultimately leads to the collapse of the monetary system, as happened in Germany after World War I.

(e) **Social**: Inflation is socially harmful. By widening the gulf between the rich and the poor, rising prices create discontentment among the masses. Pressed by the rising cost of living, workers resort to strikes which lead to loss in production. Lured by profits, people resort to hoarding, black marketing, adulteration, manufacture of substandard commodities, speculation, etc. Corruption spreads in every walk of life. All this reduces the efficiency of the economy.

(6) **Politica**l: Rising prices also encourage agitations and protests by political parties opposed to the government. And if they gather momentum and become unhandy they may bring the downfall of the government. Many governments have been sacrificed at the altar of inflation.

Merits of accounting price levels changes

In the past few years of high inflation, companies have reported very high profits on the one hand but on the other they have faced real financial difficulties. This is so because in reality dividends and taxes have been paid out of capital due to overstated figures of profits arrived at by adopting historical cost concept. Thus a change from historical cost concept to price level or inflation accounting has been recommended.

According to Gjerde, (2007) They include the following:

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(1) It enables company to present more realistic view of its profitability because current revenues are matched with current costs.

(2) Depreciation charged on current values of assets in inflation accounting further enables a firm to show accounting profits more nearer to economic profits and replacement of these assets when required.

(3) It enables a company to maintain its real capital by avoiding payment of dividends and taxes out of its capital due to inflated profits in historical accounting.

(4) Balance Sheet reveals a more realistic and true and fair view of the financial position of a concern because the assets are shown at current values and not on distorted values as in historical accounting.

(5) When financial statements are presented, adjusted to the price level changes, it makes possible to compare the profitability of two concerns set up at different times.

(6) Investors, employees and the public at large are not misled by inflated book profits because inflation accounting shows more realistic profits. Higher paper profits without adjustment for price level changes cause resentment among workers and they demand higher wages and also excessive profits attract new entrepreneurs to enter the business. Inflation accounting helps in avoiding further competition from prospective entrepreneurs.

(7) The financial statements prepared by a company adjusted to the price level changes also improve its social image.

(8) Inflation accounting also affects the investment market as it helps to establish a realistic price for the shares of a company.

Demerit of accounting price level changes

Some people are of the opinion that inflation accounting may create more problems than solving them because of the following inherent demerit of accounting price level changes:

(1) Adjusting accounts to price level changes is a never-ending process. It involves constant changes and alterations in the financial statements.

(2) Price level accounting involves many calculations and makes financial statements so complicated and confusing that it becomes very difficult for man of ordinary prudence to understand, analyze and interpret them.

(3) The concept of price level accounting appears to have more theoretical importance than practical because adjusting the accounts to the changes in the price levels may lead to window dressing of accounts due to the element of subjectivity in it. People may adjust the accounts according to the values most suited to them, thereby, making the financial statements more inaccurate.

(4) Depreciation charged on current values of fixed assets is not acceptable under the Income Tax Act, 1961 and hence adjusting it to price level changes does not serve any practical purpose.

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(5) During deflation, when the prices are falling, adjustments of accounts to price level changes will mean charging lesser depreciation and overstatement of profits

Current issues for price level changes

Price change has two broad impacts on the accounting approaches which have been described. First, general price change through inflation undermines the stability of the value of the currency unit. Reducing the purchasing power of the pound through inflation means that comparison of amounts measured in pounds at different times is distorted.

One response to the problems of price change is to restate the financial statements produced on a historical cost basis by adjusting for the change in purchasing power. The procedure is to restate the opening and closing statements of financial position by indexing all items in the opening statement of financial position and all non-monetary items including owners' capital in the closing statement of financial position using general price level indices. Monetary items in the closing statement of financial position would require no adjustments as they are already stated in current terms.

According to Lev (1999) the capital increase shown between the restated statements of financial position would be the current purchasing power profit. This approach involves only limited adjustment from historical cost and, since these can be based on publicly available indices such as the retail price index (RPI), reliability is not substantially reduced. The unit of measurement that would then be employed would be the pound of current purchasing power at the year end. The purchasing power of the owners' capital would be maintained since it is restated in these terms. This is commonly referred to as real financial capital maintenance.

However, the valuation model which adjusts asset values for general changes in prices may result in asset values that are considered to be an entire fiction. Assets do not all change prices in line with inflation. In addition, the increase that is being reported would be a combination of realized and unrealized gains, since the upward revaluation of assets by indexing them would be, increasingly, a value without the external evidence that would meet the needs of prudence and realization. A version of this approach, known as current purchasing power accounting (CPPA) was put forward in the UK but, given the limitation identified and others, it has been largely rejected.

Current cost accounting

The second major aspect of price change is the specific price changes in asset values. The historical cost approach, which recognizes revenues only when they are realized, will produce periodic profits which represent both the results of the current year's operations and gains made in previous periods which are only realized in the current period (although gains which are unrealized in the current period are excluded).

One response to this problem is to recognize unrealized gains in the period to which they relate but to treat these not as part of operating profit. Instead, they can be regarded as holding gains, i.e. gains from continuing to own assets during price rises. Measuring profit in relation to opening and closing capital restated to include holding gains of the period produces a concept of physical/operating capital maintenance, i.e. identifying the gains that can be withdrawn while permitting a business to own the same physical assets. Profit would be restated by eliminating holding gains. This is aptly described as operating profit, showing the ability of a business to produce revenues over and above the current cost of producing them through operating activities. Any adjustments necessary to eliminate holding gains from profit would be those necessary to restate historical costs, included in the comprehensive income statement, to current costs.

A version of this approach known as current cost accounting (CCA) includes such adjustments in three components. These are a depreciation adjustment, modifying depreciation to one based on the current cost of assets rather than the historical cost; a cost of sales adjustment, adjusting inventory values and purchases to current costs; and a monetary working capital adjustment, adjusting for the price change of purchases during the creditor period and sales during the debt collection period. There has been much debate about whether there should also be a fourth adjustment, known as a gearing adjustment. This is intended to reflect the benefits of having debt capital during periods of increasing prices. The last two adjustments are relatively complicated, and generally regarded as beyond the introductory level.

Considerable subjectivity is involved in identifying suitable specific price level indices for each of the possible specific price changes. The resulting reduction in reliability together with the costs of implementing the approach with all its complexities are considered to outweigh the advantages, particularly where the period of holding assets is relatively short and hence the impact of the adjustments is small. Current cost accounting has been widely abandoned as a result.

Realistic examples of accounting for changing price levels are usually very complex and beyond the scope of this book and accounting examinations at this level.

SUMMARY

Inflation redistributes income from wage earners and fixed income groups to profit recipients, and from creditors to debtors. So far as wealth redistributions are concerned, the very poor and the very rich are more likely to lose than middle income groups.

This is because the poor hold what little wealth they have in monetary form and has few debts, whereas the very rich hold a substantial part of their wealth in bonds and have relatively few debts. On the other hand, the middle income groups are likely to be heavily in debt and hold some wealth in common stocks as well as in real assets.

Accounting is known as the language of business. The basic objective if accounting is to prepare financial statements in such a way that they give a true and fair view of business. Income statement should disclose the true profit or loss made by the business during a particular period where as balance sheet must show a true and fair view of the financial position of the business on a particular date. The recording of business transactions under the assumption that monetary unit is stable is called historical cost accounting (HCA). Under HCA, assets are recorded by the business at the price at which they are acquired and there will be no change in their values even if the market values of such assets change. Likewise, liabilities are recorded at the amounts contracted for and such amounts are not revised to compensate for changes in the price level.

CONCLUSION

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Conclusively, Inflation in Accounting may, therefore, be defined as that technique of accounting by which the financial statements are restated to reflect changes in the general price level. According to the American Institute of certified Public Accountants (AICPA), "Inflation Accounting is a system for accounting which purports to record as a built in mechanism all economic events in terms of current cost. "Inflation is the most important fact of our time, the single greatest peril to our economic health". Prices of various goods and services have been rising at an alarming rate. Money is the medium of expression of values in modern life. Effects of various economic activities are measured and expressed in terms of money. For measuring anything, it is mandatory that the measure itself is constant. Money as a medium of expression of value and measure of economic activity is expected to have a constant value. But this expectation has been belied. "Constant value of money"' has remained a very unrealistic assumption. Changing value of' money has resulted in a chaos and distortion while reporting results of economic activities of business enterprises.

Recommendation

The following were recommended:

i. Adjusting accounts to price level changes is a never-ending process. It is recommended there should be constant changes and alterations in the financial statements.

ii. Price level accounting involves many calculations and makes financial statements so it is recommended that it should be analyze and be interpreted.

iii. The concept of price level accounting appears to have more theoretical importance than practical it is recommended that there should be changes in the price levels and it may lead to window dressing of accounts due to the element of subjectivity in it.

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