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   REVIEW OF LITERATURE

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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

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   APPENDIX/ANNEXURE

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IMPACT OF INFLATION ACCOUNTING ON FINANCIAL STATEMENTS AND EARNING PER SHARE

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ABSTRACT
Inflation is a common phenomenon in developing countries like India. Recently its influence on financial statements has increased on account of constant decline in purchasing power of money. The primary objective of accounting is to make financial statements give a true and fair view and such an objective is marred if the impact of changing value of money is not considered in the accounts. Inflation accounting is of utmost importance during depreciating value of money. Historical Cost Accounting (HCA) doesn't give a correct view and the profit is either understated or overstated and so is the financial position. The purpose of this study is to address the impact of inflation on financial statements and Earning Per Share (EPS) for improving the confidence of the shareholders and credibility of the financial statements.

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KEYWORDS
Earning Per Share, Historical Cost Accounting, Inflation Accounting, and Purchasing Power of Money.

INTRODUCTION
Inflation is defined as an increase in the price of a basket of goods and services that is representative of the economy as a whole. It has negative effects in social structure of a country as it affects all components of the economy. Inflation is a macroeconomic phenomenon that captures the decrease in purchasing power of a currency unit over time because of a general increase in the prices of goods and services (Beaver & Landsman, 1983). Financial statements are one of the most important tools in giving information about the enterprises to the business environment. The accounting information must assist managers, investors and other stakeholders in making decisions to use resources efficiently and effectively in the enterprise's operations in the furtherance of its profit goals. It must also provide appropriate information to assist stakeholders in evaluating the profit performance and financial position of the enterprise resulting from the use of those resources (Barton, 2000). The information provided in financial statements has to be understandable, relevant, reliable and comparable (Mirza, 2002). To have these characteristics in the financial statements, the accounting data have to be produced according to the accounting theory (generally accepted accounting principles and accounting standards) and reported according to the accounting practices (reporting system and uniform account plan). Information derived by accounting is vital in decision-making.

The usefulness of conventional financial reports based on the assumption of a stable monetary unit has become the subject of debate. The assumption of stable monetary unit is neither accurate nor realistic. Historic cost does not reflect the 'value to the business' of the assets used and owned, nor does it show the correct profit figure, or indicate the real growth of the business. It is argued that the conventional accounting reporting system does not adequately accommodate the economic reality of price changes, and that the impact of price changes on business needs to be recognized if financial reporting is to be useful for decision- making. In hyperinflationary economies, these statements are far away from reflecting the financial position and performance of the enterprises. These statements cannot meet the expectations of a wide range of users of these financial statements. The analysis of these statements cannot generate useful information in making economic decisions by shareholders, creditors, investors etc. The financial statements should be restated in hyperinflationary economies. India is one of the countries that lived with high inflation rates during the past many years. Therefore, many writers have emphasized the need to adjust company accounts to reflect changes in price-levels.

In most of the countries, primary financial statements are prepared on the historical cost basis of accounting (Whittington, Singh and Saporta, 1997) without regard either to changes in the general level of prices or to increases in specific prices of assets. In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is not useful. Money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times, even within the same accounting period, is misleading. Ever since the German hyperinflation of the 1920's, accountants have noted that high inflation causes historical cost accounting measures of income and wealth to become virtually useless (Diewert, 1998). It is also known that, in the latter half of the twentieth century, one of the greatest controversies in accounting theory and practice concerned the limitations of conventional historical cost accounting.

Financial Accounting Standards Board (FASB, 1979) stated three reasons as to why the effects of changing prices should be measured and disclosed in financial statements:

a. The effects depend on the transactions and circumstances of an enterprise and users do not have detailed information about those factors;

b. Effective financial decisions can take place only in an environment in which there is an understanding by the general public of the problem caused by changing prices; that understanding is unlikely to develop until business performance is discussed in terms of measures that allow for the impact of changing prices;

c. Statements by business managers about the problems caused by changing prices will not have credibility until specific quantitative information is published about those problems.

The FASB Concepts Statement No. l (1978), Objectives of Financial Reporting by Business Enterprises, states that "financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash flows into the enterprise" Arnold, Boyle, Carey, Cooper and Wild (1991) stated that "financial reports must now meet the wider need of informing present and future economic decisions. This is not the purpose for which the historical cost model was designed, and it is an objective which it is unlikely to achieve".

The amount originally paid to acquire the asset is its historical cost. This amount may be different from what we have to pay today to replace it. Especially in hyperinflationary economies, the difference between these two amounts (for example for fixed assets) will be considerable. As a result of this situation, the degree of the reliability, the comparability and the relevance of the accounting data and financial statements will decrease. The financial statements will not reflect the financial and economic position and the result of the operations of the enterprise truly. These incorrect and insufficient data will not meet the requirements of the internal and external users of the information. For example; the managers could not make true decisions for providing a long life for the enterprise, the investors in capital markets could make wrong investment decisions, the creditors could give credits to insufficient companies and these credits could not turn back, the government could not collect taxes in a fair and equitable way and also in long term. In a hyperinflationary economy, reporting of operating results and financial position in the local currency without restatement is also not useful. It is generally accepted that accounting systems ought to be financial measurement and communication systems which provide useful information about the enterprises to various users of the information (Barton, 2000).

In this sense, accounting has often been called as the language of business (Combarros, 2000). It is basically about collecting, organizing and reporting the financial data and finally analyzing the financial reports particularly the financial statements.
Under HCA the amounts are recorded by 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. The most significant and persistent complaint about published financial statements in recent years has been that they do not recognize the economic facts of life. In most countries, primary financial statements are prepared on the historical cost basis of accounting without regard to changes in the general level of prices. HCA is all right, if monetary unit is stable and there is no erosion in its value as a result of inflation. Inflation refers to state of continuous rise in prices. It brings downwards changes in the purchasing power of money unit. Thus, financial statements prepared without taking into account the change in purchasing power of the monetary unit lose their significance.
Inflation accounting is a system of recording all transaction on their current market price which is calculated by price index." Inflation is a reality throughout the world. Yet its effects go unrecognized in financial statements prepared in accordance with generally accepted accounting principles in most of the countries. Ignoring general price level changes in financial reporting creates distortions in financial statements such as:
1. Reported profits may exceed the earnings that could be distributed to shareholders without impairing the company's ongoing operations.
2. The asset values of inventory, equipment and plant do not reflect their economic value to the business.
3. Future earning is not easily projected from historical earnings.
4. The impact of price changes on monetary assets and liabilities is not clear.
5. Future capital needs are different to forecast and may lead to increased leverage, which increases the business's risk.
6. When real economic performance is distorted, these distorted lead to social and political consequences that damage business.
In periods of unstable prices, accounts prepared under the Historical Cost convention are considered to suffer from serious deficiencies described by the Accounting Standards Committee (ASC, 1986) as follows:
1. reported results may be distorted as a result of the matching of current revenues with costs incurred at an earlier date. The full distribution of profits calculated on that basis may result in the distribution of sums needed to maintain capital;
2. the amounts reported in a balance sheet in respect of assets may not be realistic, up to date measures of the resources employed in the business;
3. as a result of (1) and (2), calculations to measure return on capital employed may be misleading;
4. because holding gains or losses attributable to price level changes are not identified, management's effectiveness in achieving operating results may be concealed;
5. there is no recognition of the loss that arises through holding assets of fixed monetary value and the gain that arises through holding liabilities of fixed monetary value; and,
6. a misleading impression of the trend of performance over time may be given because no account is taken of changes in the real value of money.
FASB (1979) issued Statement of Financial Accounting Standards No. 33 (FAS 33), 'Financial Reporting and Changing Prices'. This statement requires mandatory supplementary information pertaining to the effects of changing prices on business operations to improve the relevant information content of financial statements. In UK, the standard on inflation accounting is SSAP 16 (Statement of Standard Accounting Practices no. 16). SSAP 16 requires current cost income statement and current cost balance sheet. Thus it can be seen that inflation accounting is widely practiced around the world. Keeping in view of these facts, the Institute of Chartered Accountants of India (ICAI) issued a guidance note on accounting for changing prices in 1982, in the hope that it will stimulate thought and encourages a wider use of the method of accounting for incorporating price level changes. It advocated the adoption of current cost accounting (CCA) method for incorporating the price level changes. But there is no separate mandatory accounting standard for inflation accounting in India.
Accounting, as it has come to be developed over the centuries, uses historical costs as the basis for income measurement and asset valuation. However, during seventies when a high rate of annual inflation had become a way of life in many countries including India, it was felt that the historical cost information should be supplemented by adequate information reflecting the effects of inflation on an enterprise. Consequently, accountants all over the world had made determined efforts to develop suitable methods for measuring the impact of changing prices on the profitability and financial condition of an enterprise. Various methods had been developed - two of them, current purchasing power accounting (CPPA) method and CCA method had gained wide exposure. The 'Guidance Note on Accounting for Changing Prices' considers the need and methods of accounting for changing prices in depth and encourages a wider use of methods of accounting for changing prices for preparation and presentation of information reflecting the effect of changing prices as a supplementary information.

REVIEW OF LITERATURE
Sweeney (1936) proposed a systematic recognition of price level changes to adjust for the distortion caused by changes in the purchasing power of money. He developed a technique which is referred to as stabilised accounting, which is the antecedent of constant purchasing power (CPP) accounting. He provided detailed descriptions and numerical examples of how to stabilise either historical costs or replacement costs by adjusting for general price level movements. His preferred approach was to apply the CPP adjustment to replacement cost values rather than Historical Cost values, as this took account of both specific and general price level changes. His publication went on to influence substantially later work, including, Accounting Research Study number six, Reporting the Financial Effects of Price Level Changes, and current purchasing power in the United States. Sweeny's publication failed to receive the attention because the problem of inflation accounting was superseded by the problem of recession and was rejected by Griffith (1937) on the grounds that it was impossible to determine which price index should be used.
Accounting Principles Board (APB, 1969) stated that the effects of inflation on a business enterprise and on its financial statements depend on the change in the general price level and the composition of its assets and liabilities. Since money loses its purchasing power during inflation, assets which are held as monetary amounts, like cash and accounts receivable, decline in real value. On the other hand, non-monetary assets like plant, equipment, and inventory appreciate in nominal terms. The same effects are valid for monetary and non-monetary liabilities.
FASB (1979) has a standard on inflation accounting, SFAS 33, which stated that there is an urgent need for enterprises to provide information about the effects on their activities of general inflation and other price changes. It believes that users' ability to assess future cash flows will be severely limited until such information is included in financial reports. It was widely believed that inflation accounting data would improve the predictive ability of accounting measures. It also recommended that the inflation accounting data should be presented in supplementary statements, as it felt users understanding of this data might be enhanced if they were able to compare it with the Historical Cost Accounting measurements included in the primary statements.
Bierman (1981) found that historical cost statements are based on accounts measured in dollars which have different levels of purchasing power. CPPA converts these into money amounts with the same purchasing power. Purchasing power of money is determined at a certain point in time through the use of price indices. The overall objective of the method is to determine the real changes in the well-being of the business and to exclude all effects resulting from the fluctuations in the value of money which do not represent real changes in financial position of a business.
Greek Management Association (1982) stated that in Greece, as in most non industrialized countries, inflation accounting research is non-existent. In spite of the fact that inflation rates over the last fifteen years were high and varied from 15 percent to 32 percent, neither the State nor the accounting profession has managed to introduce an acceptable system of monetary correction. Instead, the State has allowed businesses to revalue certain depreciable assets at a predetermined price index. So far, no research has been conducted on the impact of the price indexing policy upon the information contents of the financial statements published.
Tisshaw (1982) stated that the investor is regarded as the most skilled and dynamic of all users, and their needs subsume those of most other user groups. Thus, the issue of relevance is particularly important to this category of users. For this reason, this study focuses on this user group to evaluate the utility of inflation accounting data. He, in his valuation study, found a positive association between dividends and share values. These findings can be explained by investors viewing dividends as a return on their investment. In addition, he asserted that investors have a preference for immediate income due to their desire to reduce uncertainty.

Cross (1982) pointed out, since inflation affects companies differently, the accounting measurement errors will not be systematic across companies. Therefore, financial reports which ignore the impact of inflation undermine the utility of reported income and balance sheet totals. This led to criticism of conventional reporting practices.
Tweedie and Whittington (1984) stated that the greatest contribution that reporting the financial effects of price level changes made was to make know the actions that various corporations had undertaken with regard to price level changes. Many organizations were found to have altered not necessarily the primary financial statements but the information given to users as a whole, so as to deal with the effect of price level changes. Although, the methods had varied, they all had one common objective, to account adequately for movements in the general level of prices, and accurately measure vital information. To ignore the effects of inflation was considered to be impractical particularly when considering that decision making in business matters is a constant process; past decisions are under constant review in the light of current circumstances. No manager, or investor, or other interested party can find useful accounts which reflect the prevailing economic circumstances only once every twenty years.
The Accounting Standards Committee (ASC, 1986) commented that dividend payments, investment and financing decisions, and pricing and pay policies should not be decided upon without taking account of the effects of changing prices. Some companies have attempted to compensate for the imperfections of Historical Cost Accounting by adopting modified Historical Cost accounts, under which certain assets are included in the balance sheet at revalued amounts. However, most of these companies undertake revaluations comparatively infrequently and do not revalue all their assets.
Thies and Sturrock (1987) conducted a research over a sample of 50 large manufacturing firm using replacement cost data for the period 1977-1983. The findings showed that rankings of historical cost based financial ratios did not match well with rankings of replacement cost-based ratios. The data also indicated that historical cost based financial ratios often grossly misrepresent the relative financial strengths of companies.
Okumus (2002) evaluated the effect of inflation on measures of profitability in Turkish Banking. In his paper, profitability ratios based on pre inflation and post inflation adjusted financial statements, are compared for the Turkish banking industry over the period 1989-1995. It appears that inflation adjustment, based on the Current Purchasing Power procedure, decreased the level profitability and altered the ranking of profitability ratios by bank groups significantly. This reflects the importance of considering the potentially distorting effects of inflation.
Karapinar and Zaif (2005) did the first empirical study on the effects of inflation on financial ratios. In their study, they examined the effects of inflation accounting practice on companies' financial ratios. Their sample covered the 73 non-financial companies listed Istanbul Stock Exchange as of 2003. The ratios were calculated on both historical and adjusted numbers of financial statements to form two sets of ratios. Results showed that there was no significant change in liquidity, financial, profitability and activity ratios except fixed asset turnover ratios.
Akdoğan, Aktas and Unal (2009) extended the number of companies in the sample of Karapınar and Zaif. The results covering 146 companies were consistent with the findings of Karapınar and Zaif's study. Their results revealed that a statistically significant change for the whole sample occurs only on Total Assets Turnover. Other ratios did not show any considerable difference.

IMPORTANCE OF THE STUDY
Inflation accounting is a methodology proposing to restate the books at current purchasing power and is of high importance during price increase. It requires statements to be adjusted according to price indices, rather than relying on historical cost. Companies operating in countries like India, where inflation is very high should update their statements periodically to make financial data relevant to current economic and financial conditions. A great deal of research has focused on inflation accounting and few consistent conclusions have yet to be reached about the antecedents and outcomes of inflation accounting. This research study establishes that the value of financial reporting will improve and thereby boosting the decision making abilities of the multiple users apart from enhancing the standing of financial statements. The basic aim of this research paper is to see the difference in overall profitability and EPS under historical cost and inflation accounting.

OBJECTIVES OF STUDY
The following objectives are formulated for the present study:
1. To ensure a true and fair view of the financial statements in terms of operating results and financial position of the business.
2. To conceptualize the CPP method through which financial accounts can be adjusted for changing prices.
3. To review the conceptual framework within which the utility to the investors of accounting data in general, and inflation accounting data in particular, might be evaluated.
4. To identify the impact of inflation accounting on the credibility and fairness of the financial statements.
5. To study the resultant differences in EPS based on adjusted and historical financial data.

CURRENT PURCHASING POWER (CPP) METHOD AND FINANCIAL STATEMENTS
In the tables given below the author has done a study of a private company based on hypothetical financial data for studying the impact of inflation on its profitability and EPS. It is evident in the given case study the real profit is halved under inflation accounting so is the EPS (Please refer to annexure given at the end of the study).

CONCLUSION
To conclude, inflation is inevitable and there is need to revamp existing accounting practices negating its impact on the financials of the companies. Financial Statement is of utmost importance to various stakeholders like external agencies and owners of the company and should assist various parties in evaluating the business and decision making. Financials lose its vigour in the period of rising prices as the value of money is eroded and the basic objective of maximization of wealth of shareholders is defeated. Inflation accounting has the philosophy of keeping the value of money intact and is of quite significance in the case of rising prices as the results based on historical accounting are misleading and actually undermine the profitability and shareholders' value. Inflation accounting should be mandatorily followed and relevant accounting standard should be mandatorily followed by corporate bodies. Financial Statements should be unfazed with the movement in prices and inflation accounting is a tactic to combat the depreciating value of money and boost the confidence of investors.

RECOMMENDATIONS FOR FUTURE RESEARCH
The present research paper focuses on the theoretical framework behind inflation accounting and its related application. The author recommends for future research on the following lines:
1. To study the impact of restated financials of listed companies on their EPS and related market capitalization in comparison with historical accounting.
2. To corroborate the impact of inflation on erosion of shareholders' equity of select companies.
3. Studying stock price of listed companies as true index of economy driven by real purchasing power of money.
4. Develop explicit plans to diffuse the impact of inflation on accounting.
5. Making Indian Accounting Standard 29 mandatory for Indian Companies.

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ANNEXURE

Table 1 shows the Balance Sheet of Extrovert Consulting for Financial Years ended on 31st March 2011 and 2012.

TABLE 1

Extrovert Consulting Private Limited
Balance Sheet as at 31st March 2012
(Amount in Rs.)

Particulars	As On 31st March 2012	As On 31st March 2011
I. EQUITY AND LIABILITIES		
1 Shareholders' Funds		
a) Share capital	136,000	136,000
b) Reserves and surplus	39,341,092	30,725,740
c) Money received against share warrants	-	-
2 Share Application Money Pending for Allotment	-	-
3 Non-Current Liabilities		
a) Long-term borrowings	6,588,544	4,168,177
b) Deferred tax liabilities	-	-
c) Other long term liabilities	13,298,583	7,189,500
d) Long-term provisions	-	-
4 Current Liabilities		
a) Short-term borrowings	-	-
b) Trade payables	2,156,525	6,820,059
c) Other current liabilities	8,395,637	8,782,186
d) Short-term provisions	12,846,491	9,542,279
Total	**82,762,872**	**67,363,941**
II. ASSETS		
1 Non-Current Assets		
a) Fixed assets		
i) Tangible assets	14,341,769	9,834,216
b) Non-current investments	-	-
c) Deferred tax assets (net)	146,087	(39,916)
2 Current Assets		
a) Current investments	60,000	85,000
b) Inventories	-	-
c) Trade receivables	24,929,516	28,556,321
d) Cash and cash equivalents	11,750,845	8,244,752
e) Short-term loans and advances	31,534,655	20,683,568
f) Other Current Assets		
Total	**82,762,872**	**67,363,941**

Table 2 calculates the loss on account of monetary items being restated at closing index price 115 and average rate of 107 against the base price of 100. The gain or Loss is the difference between value of net monetary assets at historical cost and at current purchasing price.

TABLE 2

INR

	Calculation of Monetary Gain (Loss)			
		Historical	**C.F.**	**CPP**
	Net Monetary Assets as on 31.3.11	32,425,117	1.15	37,288,884
Less	Expenses	(76,233,863)	1.07	(81,552,504)
	Taxes	(4,228,090)	1.00	(4,228,090)
Add	Sales	92,758,782	1.07	99,230,324
	Income	154,417	1.07	165,190
	Net Monetary Assets	44,876,363		50,903,805
	Net Monetary Assets HC			44,876,363
	Difference*			**6,027,442**
	***Stands for Monetary Loss on account of Inflation**			

Table 3 shows the calculation of net monetary assets used in Table 2.

TABLE 3

Statement of Net Monetary Assets		
	31st March 2012	31st March 2011
Current investments	60,000	85,000
Trade receivables	24,929,516	28,556,321
Cash and cash equivalents	11,750,845	8,244,752
Short-term loans and advar	31,534,655	20,683,568
Current Assets	**68,275,016**	**57,569,641**
Trade payables	2,156,525	6,820,059
Other current liabilities	8,395,637	8,782,186
Short-term provisions	12,846,491	9,542,279
Current Liabilities	**23,398,653**	**25,144,524**
Net Monetary Assets	**44,876,363**	**32,425,117**

Table 4 brings into account the real profit by following inflation accounting and the related impact on EPS. The data given below indicates the profit has actually gone down from 86 lakhs to 32 lakhs as the inflation has eroded the shareholders wealth and the profit as per historical accounting is overstated. Further consequent to correction in profits the EPS has gone down by Rupees 400 per share which is quite alarming and unfolds the significance of inflation accounting on the business.

TABLE 4

Extrovert Consulting Private Limited

Income Statement Comparative as per Historical Cost and CPP Method for the year ended 31st March 2012

(Amount in Rs.)

	Particulars	For The Year Ended 31st March 2012	Factor	For The Year Ended 31st March 2012
I.	Revenue from operations	92,758,782	1.07	99,230,324
II.	Other income	154,417	1.07	165,190
III.	**Total Revenue (I + II)**	92,913,198		99,395,515
IV.	Expenses:			
	Employee benefits expense	28,413,860	1.07	30,396,222
	Financial costs	1,661,008	1.07	1,776,892
	Depreciation and amortization expense	3,679,682	1.15	4,231,635
	Other expenses	46,158,995	1.07	49,379,390
	Total Expenses	79,913,545		85,784,139
V.	Profit before exceptional and extraordinary items and tax (III - IV)	12,999,653		13,611,376
VI.	Exceptional items	-		
VII.	Profit before extraordinary items and tax (V - VI)	12,999,653		13,611,376
VIII.	Extraordinary items	-		
IX.	Profit before tax (VII - VIII)	12,999,653		13,611,376
		14%		
X.	Tax expense:			
	1) Current tax	4,507,791		4,507,791
	2) Deferred tax	(186,003)		(186,003)
	3) Previous Year Tax	62,514		62,514
XI.	Profit/(Loss) for the perid from continuing operations	8,615,352		9,227,074
XII.	Loss on Purchasing Power			(6,027,442)
XV.	Profit/(Loss) for the period (XI + XIV)	8,615,352		3,199,632
XVI.	Earnings per equity share:			
	Basic & Diluted	633		235

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