RESTRICTED

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS

REPORT

OF

THE STUDY GROUP

ON

INFLATION ACCOUNTING

OCTOBER, 1978

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Ministry of Finance
Department of Economic Affairs

Report of the Study Group on Inflation Accounting

Introductory

Business accounts in India, as elsewhere, are maintained traditionally on the basis of historical costs. Accounts based on historical costs have the merits of simplicity and objectivity and, until recently, have commanded universal acceptance. Sharp and prolonged inflation in recent years however has given rise to doubts about the usefulness of financial statements based on historical costs. It is widely felt that, when prices are changing, historical cost accounting (HCA) may present a misleading picture of the financial position of a business undertaking and its performance over a given period. With rapid inflation policies regarding product pricing and profit distribution based on historical costs, it is apprehended, may unwittingly result in erosion of capital and financial instability of business concerns. The problem acquires urgency in the case of undertakings belonging to the public sector since failure to maintain the capital of such undertakings implies the consumption of capital by the community with consequent ill-effects on future growth of the economy. If capital gets eroded, it is not possible to maintain the essential services like transport and power even on their existing scale.

2. The possibility of products of public enterprises like power projects in India being underpriced under a system of historical cost accounting was pointed out by World Bank sometime ago in the course of negotiations for a credit for one of the Super Thermal Power Stations. The Bank suggested consideration of a system of periodic revaluation of assets to ensure proper maintenance of the capital of such projects.

3. While the deficiencies of historical cost accounting are generally acknowledged there is as yet no unanimity among experts about their remedy. Although expert opinion seems to be crystallizing in favour of some form of current cost accounting, whether historical cost accounting should be abandoned altogether, and, if so, what would be the best alternative continues to be debated by accountants and economists (vide for instance the series of articles published on the subject in the Harvard Business Review in 1976).

4. Besides, complete change-over from historical cost accounting to any form of accounting for inflation has wide policy implications which call for careful consideration. Although some of the public enterprises in India - Bharat Heavy Electricals Limited (BHEL) for instance - have in recent years attempted current cost accounting as a supplement to the traditional presentation of accounts on the basis of historical costs, the accounting system of public enterprises in

India continues to be based on historical costs. Reasons for continued reliance on HCA despite its deficiencies are several. The subject has so far received very little public attention in India and, unlike in U.K. and U.S.A., until recently there has been no move on the part of the professional accounting bodies to consider proposals for a radical reform of the accounting practices. Moreover, accounting for inflation in most public enterprises might present their working results in poor light. Pricing on the basis of current costs might provide impetus for sharp upward revision of prices of products. It could also have immediate adverse impact on revenue realisation from corporate taxation. On these considerations any change in the accounting conventions based on historical cost was considered inadvisable.

5. Even so, it was felt that adherence to historical cost accounting under inflationary conditions might be detrimental to the long run interests of the economy. Considering however the controversy still prevailing on the various issues raised by inflation accounting and the slow progress even in advanced countries towards the general adoption of any form of inflation accounting, it was thought that before taking any definite step in the matter it would be useful to set up a small group within the Government to prepare a preliminary study which could be put up to the Committee of Economic Secretaries for deciding the form of further action. Accordingly, a study group was set up in 1977 in the Economic Division of the Department of Economic Affairs in the Ministry

Finance with Dr. R.M. Honavar, Chief Economic Adviser as Chairman to undertake a preliminary study of the need for and feasibility of inflation accounting in India and submit a report for consideration by the Committee of Economic Secretaries. Apart from the Chairman, the Group consisted of the following members:

1. Shri R. Rajagopalan, Chief Cost Accounts Officer, Ministry of Finance.

2. Shri S.M.Patankar, Adviser, Bureau of Public Enterprises (Shri Patankar succeeded Shri N. Rajan who was originally in the Group).

3. Shri O.P. Bhardwaj, Director, Central Board of Direct Taxes.

4. Shri N.D. Bhatia, Additional Director, Deptt. of Company Affairs.

5. Dr. A. Bagchi, Director, Fiscal Policy Section. (Convenor).

6. The Group held several meetings in the course of the last one year. Since it was a preliminary study the Group did not think it necessary to issue any questionnaire or elicit opinion from public bodies or individuals formally. Informal discussions were however held by the members of the Group with Shri K.P.Taimini, Member, Central Electricity Authority and Shri R. Bhandari, Accounts Officer of BHEL. The Group is indebted to Shri Taimini and Shri Bhandari for sparing their valuable time for the discussions. The Group also wishes to thank the Indian High Commissions in U.K. and Australia for supplying official reports and other literature on the subject promptly. It was thought that it would be

possible for the Group to submit its report within a few months. In view of the continued controversy in the area and the fate of the proposals of the Steering Group set up in U.K. to give shape to the recommendations of the Sandilands Committee the Group felt it advisable to watch the developments for some time more. The study presented below takes note of the controversies and seeks to survey the issues thrown up by the "great debate" rather than formulate any specific guideline for changing the existing accounting conventions. A few suggestions have been offered to remedy the deficiencies of the existing system. However, as the subject has not attracted as much attention in India as it has in the English speaking countries, it would perhaps be desirable to have the suggestions debated in public before taking any action.

7. This Report is in two parts. The first part which represents the majority view consists of three chapters. The first chapter discusses the deficiencies of the historical cost convention and presents a survey of opposing viewpoints on the merits of historical cost accounting as against accounting for inflation; Chapter 2 considers alternative approaches to inflation accounting and Chapter 3 goes into some of the practical problems of current cost accounting. Part II of the Report sets out the views of two members S/shri R. Rajagopalan and N.D. Bhatia and also consists of three chapters.

P A R T - I

CHAPTER 1

HISTORICAL COST ACCOUNTING: THE DEFICIENCIES AND THE CASE FOR AND AGAINST

Uses of Financial Statements

1.1 Financial statements of business enterprises serve a wide variety of purposes. The profit and loss account affords the measurement of the income of an enterprise during a given period which is of vital interest to the owners of the concern. Under a system of income taxation, the profit and loss account forms the basis of assessment of business income. Where, as in corporate enterprises, ownership is divorced from management, a reliable measure of income is essential for the periodic evaluation of performance of the enterprise as also for important managerial decisions such as in the matter of pricing of the product of the concern and distribution of its surplus. Together with the balance sheet, which gives an idea of the financial worth of a concern at a given point of time, the profit and loss account constitutes the principal source of information required by investors, lenders, shareholders and financial analysts. Information regarding the surpluses and financial worth of business enterprises is also of interest to planners and national income statisticians and plays an important role in decisions having a vital bearing on the economy such as mobilisation of resources for development and their allocation.

Existing accounting conventions and their deficiencies

1.2 Following the practice prevalent in U.K. and elsewhere, the Companies Act, 1956 requires the Board of Directors of every company to lay before the company at every general meeting:

(a) a balance-sheet as at the end of the relevant period and

(b) a profit and loss account for that period.[1]

Section 211 of the Companies Act lays down that "every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year". It also enjoins that "every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year". The form in which the balance sheet is to be drawn up and the requirements as to profit and loss account are also laid down in the Act.[2] What constitutes a true and fair view of the state of affairs of the company or its profit and loss for a given financial year is not spelled out in the Act. However, as in U.K., it is now well established that the application of generally accepted principles of accounting will lead to a true and fair view being shown. This is the accepted position in the income-tax law too. Under the Income-tax Act 1961, profits

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1. See Sec. 210 of the Companies Act.

2. Parts I and II of Schedule VI to the Companies Act, 1956.

and gains of business are computed "in accordance with the method of accounting regularly followed by the assessee"[3] and the tax authorities cannot interfere unless by that method the true income or profits and gains cannot be arrived at.[4]

1.3 Although there are variations in application, a basic tenet of accounting principles followed in India, as in most countries, is the convention of historical costs. Assets are entered in the accounts at their historical cost. Expenses on material used in business are charged in the accounts ordinarily at their original cost. Market price is adopted for valuation of stock-in-trade but only when it is lower than original cost. User cost of depreciable assets - depreciation - is also charged as fixed percentage of historical costs. Although there is no bar in law to revaluation of assets, for income tax purposes no cognizance is taken of such revaluation. Under the Income-tax Act, depreciation can be charged only with reference to the original cost of an asset as reduced by depreciation already allowed. Cost of material too can be charged on the "first-in-first-out" (FIFO) basis. The principle of last-in-first-out (LIFO) and the "base stock" method, it was held by courts, will be rejected if they do not afford a true picture of the profits in a particular year.[5]

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3. Sec. 145(1) of Income-tax Act, 1961.
4. CIT vs. Singari Bai 13 ITR 224.
5. Kanga & Palkhivala, The Law & Practice of Income Tax, seventh edition, Vol.I, p.879.

1.4 While the historical cost convention provides a simple and at the same time objective basis for accounting and has been in vogue since long, its usefulness, it is increasingly felt, is greatly undermined during inflation. Doubts have been expressed even about the meaningfulness of accounting measurements based on unchanging money unit when its real value undergoes change. The most obvious reason which gives rise to such doubts is that when prices are changing leading to variations in the real value of money the results of arithmetic operations using the same money unit ceases to be meaningful and becomes difficult to interpret. For instance, measuring the value of total assets of a concern at a particular date by adding up the cost of assets acquired at different points of time in the past is as meaningless and objectionable as adding up currencies of different countries to arrive at the total figure of an amount of money. Adding up the cost of inventory of say, Rs.10,000 purchased one year ago, with Rs.70,000, cost of land acquired twenty five years ago, and Rs.80,000, depreciated cost of equipment purchased in the course of the preceding five years is, as anomalous as adding up say, 10,000 U.S. $ with 20,000 Canadian $, £ 60,000 and Rs.50,000.[6]

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6. Inflation Accounting by Sidney Davidson and others (McGraw Hill, 1976) page, 5.

1.5 That apart, accounting profit based on the historical cost convention is a measure of business surplus in historical money terms derived by matching historical money cost with realised money values. While this measure may be useful for certain purposes, for several reasons doubts arise as to whether profits so computed can be regarded as a unique measure of business surplus or used as a reliable base for taxation. Two fundamental reasons why conventionally measured profits cannot be accepted as a satisfactory measure of business surplus, as put forward by Mathews and Grant[7], the noted authorities on accounting, are:-

(i) When the value of money is changing, accounting profit based on historical costs does not provide a measure of current income, defined as the difference between revenue expressed in current prices and costs and expenses expressed in current prices. For, under such conditions the value at which the costs and revenues are recorded in determiring profit are not consistent. When costs and expenses are valued in monetary units which differ from one another and also differ from units used to measure revenue items, accounting profit cannot yield a measure of current income. For purposes of policy regarding changes in total output and its composition, it is current income which is relevant. Decisions based on historical cost profits are apt to create unintended and undesirable distortions in resource allocation and in the pattern of income distribution.

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7. "Profit Measurement and Inflation" by R. Mathews and J.Mcb Grant in Inflation and Company Finances (Sydney Law Book Company of Australasia, 1962) reprinted in Readings in the Concept & Measurement of Income edited by R.H. Parker & G.C. Harcourt (Cambridge University Press, 1969).

(ii) Another major drawback of historical cost accounting (HCA) profit as a measure of business surplus is that it fails to maintain the real value of the capital of the enterprise during a period of rising prices. While adherence to historical money costs ensures preservation of the money capital contributed by shareholders, when prices are rising, maintenance of "money capital" will not by itself help maintenance of real value of the capital. In other words, capital may get eroded. It may be possible to augment the shareholders' funds by retaining adequate funds out of the profits of the company, but such retention is not easy when taxation, dividend and wages are related directly or indirectly to the level of HCA profits. To quote the noted authors referred to above:

> "Unless profits can be retained, the enterprise will become short of liquid funds or undercapitalized and fresh capital will have to be raised to maintain the same volume of physical assets. Because this under-capitalization occurs as a result of conventional accounting procedures, management may not become aware of its existence until the financial position of the enterprise has been seriously weakened. In the initial stages of inflation many firms finance the replacement of stocks and fixed assets at higher prices by increasing short-term indebtedness. As a result their financial stability is undermined."

Heavy reliance on debts affects the liquidity position of the company. Thus there is an inherent tendency of traditional accounting to produce short-term as well as long-term financial instability.

1.6 Changing prices also reduce the usefulness of profits measured through HCA as the base for taxation. When the measuring rod itself is changing, magnitudes measured with it cannot obviously be compared. Hence

income measured in terms of money unit can scarcely be regarded as an index of welfare or ability to pay unless the real value of the unit remains constant. For the same reason, under inflationary conditions the utility of financial statements based on HCA for evaluation of managerial performance - i.e. for purposes of "stewardship accounting" - is also underlined.

1.7 HCA also fails to reveal the relative impact of inflation as between different firms. The effect of inflation as between different firms varies depending upon the character of the industry and management policies. When no adjustment is made for changes in the purchasing power of the money unit, the impact of changes in prices gets submerged with all the other factors affecting the performance of the firm, and in such situations financial statements based on HCA fail to provide a yardstick for judging the relative impact of inflation on different firms.[8]

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8. Sidney Davidson & others, op. cit.

This deficiency of HCA finds recognition in the following statement of the Financial Accounting Standards Board of U.S.A.:

> "Changes in the purchasing power of the dollar affect individual enterprises differently, depending on the amount of the change and the age and composition of the enterprise's assets and equities. For example, during periods of inflation, those who hold monetary assets (cash and receivables in fixed dollar amounts) suffer a loss in purchasing power represented by those monetary assets. On the other hand, in periods of inflation, debtors gain because their liabilities are able to be repaid in dollars having less purchasing power. In periods of deflation, the reverse is true. Conventional financial statements do not report the effects of inflation. or deflation on individual enterprises.9

Moves towards reform of accounting conventions

1.8 Although the deficiencies of HCA narrated in the preceding section have been obvious to accountants and economists since long, moves towards a reform of conventional accounting principles did not gather momentum until recently. Continued inflation over the last few years has lent urgency to the search for alternatives.

1.9 While some of the deficiencies of HCA can be corrected through devices like periodic revaluation of fixed assets and LIFO or"base stock"method of stock valuation, the concept of accounting profit, it is

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9. Financial Accounting Standards Board, "Reporting the Effects of General Price Level Changes in Financial Statements", FASB Discussion Memorandum (1974).

suggested by several leading authorities on the subject, should be replaced or supplemented by concepts which would be more useful in judging managerial performance and also other purposes. Following the celebrated work of Edwards and Bell,[10] money income, it is suggested by many, should be divided into two parts: (i) operating gains or current operating profit and (ii) holding gain. "Current operating profit" is "the excess, over a period, of the current value of output sold over the current cost of related inputs", while 'holding gain" is defined as any excess of the current value of an asset held by a firm over its historical cost.[11] The distinction between "current operating profit" and "holding gain" is best brought out through a numerical example. Supposing the sale proceeds of the product of a company are Rs.130, if the historical cost of the inputs including depreciation of fixed assets happens to be Rs. 100, the historical cost profit would be Rs. 30. If however, the current value of the inputs including depreciation is Rs. 110, the current operating profit would be Rs. 20 and there would be a holding gain of Rs. 10. Since the two kinds of gains -

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10. E.O. Edwards and P.W. Bell, The Theory and Measurement of Business Income (Berkeley and Los Angles 1961).
11. For a suggestion to this effect see the Introduction to Readings in the Concept and Measurement of Income by Parker & Harcourt op.cit. These concepts are refined further in the Report of the Inflation Accounting Committee which was chaired by F.E.P. Sandilands (HMSO 1975), Chapter 4.

operating profits and holding gains - normally result from quite different types of managerial decisions, for purposes of a evaluation, it has been suggested, the two should be separated in the accounts.[12] For purposes of taxation according to ability to pay, it is suggested further, "holding gains" should be split up into their real and fictitious elements. "Real income" is measured only by adding operating profits to "real" holding gains.

1.10 The need for evolving a method of correcting the deficiencies of HCA has been recognised also by leading accounting bodies in UK and U.S.A. since long. The Council of the Institute of Chartered Accountants in England and Wales accepted as long ago as 1952 that HCA profits are not a measure which can be relied upon for purposes of distribution, price fixing, wage negotiations or taxation. The Council however was unable to find an acceptable alternative.[13] Similarly, the American Institute of Certified Public Accountants (AICPA) brought out a study on the subject in 1963 and thereafter issued recommendations for adoption of "purchasing power accounting" by U.S. compa nies.[14]

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12. "Price Changes and Income Measurement" by P.W. Bell, in Modern Accounting Theory edited by M. Backer (Prentice Hall 1966).

13. Institute of Chartered Accountants in England and Wales, Recommendation on Accounting Principles No.15 (May 1952), quoted in, Parker and Harcourt, op. cit.

14. Accounting Principles Board's Statement No.3. An excellent account of the development of the general purchasing power method in USA and the current purchasing power method in the UK is given in Sandilands Committee Report, Chapter 9.

1.11 Progress towards reform of accounting principles has however been slow. It was only in 1973 that the Accounting Standards Steering Committee of U.K. issued a paper on "Accounting for Changes in the Purchasing Power of Money" (ED 8) and the professional accounting bodies of U.K. issued a provisional Statement of Standard Accounting Practice (SSAP7) urging the adoption of "purchasing power" accounting to supplement financial statements based on historical cost. Thereafter the U.K. Government appointed a Committee on Inflation Accounting - the Sandilands Committee - to examine whether and, if so, how company accounts should allow for changes in costs and prices having regard to various factors. The Report of the Sandilands Committee was published in the second half of 1975. The Committee recommended the introduction of 'current cost accounting' (CCA) in U.K. but left it to a Steering Committee to work out suitable standards to implement the suggestion. The Steering Group headed by Douglas Morpeth brought out an "exposure draft" - the now famous ED 18 - for consideration by accountants. In July last year, however, the members of the English Institute of Chartered Accountants voted against the proposals contained in the exposure draft being made mandatory. Another group was set up thereafter by the Accounting Standards Committee - the professional body with overall responsibility for rule making in the

private accounting area in U.K. - with William Hyde, Chief Accountant of Oxford University to work out interim guidelines for adoption by large companies. The Hyde Group's guidelines were released in November 1977 and it appears that the suggestions put forward in their guidelines are being acted upon by a number of companies in Britain. Meanwhile the Inflation Accounting Group headed by Douglas Morpeth is working on new draft CCA standard expected to be ready next spring.[15]

1.12 In U.S.A. too progress towards change in the method of accounting has been halting. A proposal was put forward by the Securities and Exchange Commission in March 1976 requiring the large firms to disclose certain supplementary information about current replacement cost of inventories, cost of sales and depreciation that would have been charged on current value basis along with a description of the methods used. This met with some resistance in the first year (1977). Meanwhile the Financial Accounting Standards Board of U.S.A. has commissioned a project on the conceptual framework of financial accounting and reporting, and further action in the matter may be deferred until the project is completed. In Australia too where current cost accounting was to become mandatory, the original schedule has been delayed at least until July 1979. Other countries which have issued some proposals in this regard - but no rules yet - are Canada, New Zealand, South Africa and Japan. In France rules for revaluation of assets have been introduced by the Government although its securities commission, the COB, has decided not to require listed companies to make current purchasing power disclosures. In Germany a recommendation was issued by the accountancy profession for CCA in

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15. Financial Times, September 19, 1978.

1975 but none of the large companies seems to have heeded this suggestion. As one observer comments, "it looks as if HCA will take a little longer to dislodge than may have been imagined a few years ago."[16] However the principles of CCA are well established in Holland, and in Brazil a "replacement cost system" of accounting has been mandatory since 1964.[17]

Reasons for Reluctance to abandon Historical Cost Accounting

1.13. A major factor underlying the slow progress towards any change in accounting conventions is the reluctance of practising accountants to abandon the historical cost convention. Parker and Harcourt advance four possible reasons for such reluctance:[18]

(i) Accountants are "practical" men and like most practical men they tend to "repeat the mistakes of their forefathers" and to avoid solving theoretical problems.

(ii) Historical cost is needed for taxation purposes in most countries. There is little chance of HCA being given up as long as this position continues.

(iii) There is no consensus about an alternative method of accounting.

(iv) If historical costs are departed from, financial statements would lose their objectivity.

1.14. Not all of the reasons listed above are however accepted as valid. Historical cost, it is pointed out by critics, is not necessarily more objective than market value. After all,

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16. "Inflation Accounting" by Michael Lafferty, Financial Times, January 16, 1978.
17. Sandilands Committee Report, Chapter 19.
18. R.H. Parker & G.C. Harcourt, op.cit.

depreciation based on historical cost is an estimate. The historical cost of a manufactured article often depends on a number of quite arbitrary decisions about allocation of overheads between jobs or processes.[19] The stock-valuation rule - lower of cost or market value - followed under HCA also involves determination of current values. In any case, as one professor of accounting put it, "Objectivity without relevance is not much of a virtue."[20]

1.15 Lack of agreement about an acceptable alternative to HCA has been a real obstacle to progress towards accounting reform. Opinion continues to be divided among accountants and economists about the advisability of giving up historical costs for purposes of accounting and more so about a satisfactory alternative.

The Case for Historical Costs

1.16 Apart from the merit of objectivity, the case for HCA is argued also on the ground that (i) inflation accounting is not necessary either for the stability or for the growth of business enterprises; (ii) inflation accounting will provide a further spurt to price rise and (iii) if price adjustment is allowed in the computation of business profits for taxation, there should be indexation for income from all other sources, which is not simple and might lead to a drastic fall in Government's revenue from income tax.

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19. Ibid.
20. "Economic and Accounting Concepts of Income", by David Solomons, Accounting Review, 1961 reprinted in Readings in the Concept and Measurement of Income edited by Parker & Harcourt.

1.17 The argument that inflation accounting is unnecessary has been put forward forcefully by Prof. Robert N. Anthony of Harvard Business School in a recent article.[21] Comparing the case of a firm which prices its products on the basis of historical costs with one which goes by replacement cost, Prof. Anthony argues that even under inflation a firm which merely recovers historical costs should have no difficulty in finding funds for replacing its assets, for it can secure the requisite additional funds by raising debts and equity capital in the same proportion as before provided the firm pays the cost of both borrowed funds and equity capital at a higher rate than before to allow for inflation.

1.18 A crucial element in Prof. Anthony's model is the assumption that capital can be raised to finance replacement of assets at current cost if the yield rate is raised suitably to compensate for the price rise. As pointed out by the Australian Committee of Inquiry into Inflation and Taxation (Mathews Committee), there are limits to the extent to which yield rate on equity capital or borrowed funds can be raised by a firm or funds can be procured through borrowing from the capital market. These limits are set by:

(a) Constraints on the firm's ability to continuously raise prices. These may arise from official price control or consumer resistance;

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21. "A Case for Historical Costs" by Robert N. Anthony, Harvard Business Review, November-December, 1976.

(b) Constraint on the firm's ability to continue borrowing or raising fresh capital to maintain operating capacity. This will depend on the flow of funds through the capital market and the attitude of creditors and investors to the firm's debt-equity position;

(c) Restrictions on the firm's ability to reduce its profit distribution which are set by the level of after-tax profits;

(d) Constraints on the firm's ability to reduce the scale of its operation which are set by falling profitability and ultimately by the liquidation of the business itself.[22]

1.19 It is undeniable that unless a firm is able to raise capital continuously to maintain the scale of its operations, when the rate of inflation is high, it will cease to be a viable unit. Historical cost accounting increases the dependence of a firm on borrowings and thus hastens the process of its extinction. One reason for the widespread sickness of Indian industries in recent years could be their excessive reliance on borrowed funds and failure to provide for replacements. HCA may have aggravated this phenomenon.

1.20 The figures disclosed in the balance sheet of Bharat Heavy Electricals Ltd - the only public sector undertaking in India which seems to have attempted inflation accounting - serve to bring out the difference that accounting on the basis of current cost of assets can make to the profitability position of such undertakings.

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22. Report of the Committee of Inquiry into Inflation and Taxation (Australian Government Publishing Service, Canberra, 1975).

As the summary of the results reproduced below would show, profits after tax would come down substantially if adjustments are made for current cost of assets used up:

(Rs. crores)

Bharat Heavy Electricals Ltd.

		1975-76		1976-77
Under HCA				
Profit before tax (HCA)		54.66		62.95
Tax provision		32.20		31.50
Profit after tax		22.46		31.45
Under CCA				
Profit before tax (HCA)		54.66		62.95
Less: Cost of sales adjustment	2.66		1.69	
Cost of additional depreciation	10.71		12.89	
		13.37		14.58
Profit before tax (CCA)		41.29		48.37
Less tax (on CCA profit)		23.84		27.93
Profit after tax (CCA)		17.45		20.44

1.21. It will be seen that in 1975-76 PAT under CCA works out to Rs.17.45 crores if tax is charged on the basis of CCA profits as against Rs.22.46 crores under HCA. The corresponding figures for 1976-77 are Rs.20.44 as against Rs.31.45 crores. Since however, tax is now charged on HCA, if adjustments are made for CCA, profits left after tax work out to Rs.9.09 crore in 1975-76 and Rs.16.87 crores in 1976-77, i.e. come down by about 50 per cent of PAT on HCA basis.

1.22 Aggregative data on company finances also afford some idea of the extent to which HCA profits overstate the true surpluses of companies and show how unreliable HCA profits can be as a policy guide in the matter of distribution and pricing in the Indian context. Table I below sets out the figures of written down value (WDV) of fixed assets, depreciation provision, profits after tax on historical cost basis, a rough estimate of current cost profits and dividends actually distributed for the years 1970-71 to 1975-76. CCA profits given in line 8 have been worked out by applying the average rate of depreciation (line 3) to the w.d.v. of fixed assets adjusted for price change with the wholesale price index of machinery and transport equipment (1970-71 = 100). It will be seen that HCA profits (after tax) might have been adequate to cover the cost of assets at the ruling level of prices of machinery, until 1974-75. With persistent inflation, the gap between the two measures of profits widened and in 1975-76 CCA profits came down to a bare Rs.32 crores. Distribution of dividend of Rs.117 crores in that year was obviously imprudent as the profits were insufficient for such distribution. The deficiencies of HCA show up even more glaringly in the case of public enterprises. As may be seen from Table II, while HCA profits (after tax) of the Central Government's enterprises engaged in production aggregated to about Rs.254 crores, Rs.80 crores and Rs.147 crores during the years 1974-75, 1975-76 and 1976-77, CCA profits were no more than Rs.111 crores, (-)Rs.124 crores and (-)Rs.74 crores in the said

Table 1

Profits of Large and Medium Public Limited Companies under Historic Cost Accounting and Current Cost Accounting

(RS. CRORES)

	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76
1. W.D.V. of Fixed Assets	2513.41	2588.49	2740.92	2880.51	3263.81	3581.89
2. Depreciation Provision of the year	290.81	304.51	329.72	349.43	389.29	404.63
3. Line 2 as percentage of line 1	11.57	11.76	12.03	12.13	11.93	11.30
4. Adjusted value of Fixed Assets(line 1 adjusted for price change*)	2513.41	2717.91	3069.83	3543.03	5091.54	6196.67
5. Depreciation on adjusted W.D.V. (line 4 x line 3)	290.80	319.63	369.30	429.77	607.42	700.22
6. Depreciation adjustment (line 5 minus line 2)	(-)0.01	15.12	39.58	80.34	218.13	295.59
7. Profit after tax (under HCA)	299.12	298.44	313.52	385.68	522.13	327.80
8. CCA Profit(with only depreciation adjustment) (line 7 minus line 6)	299.13	283.32	273.94	305.34	304.00	32.21
9. Dividends(ordinary)	134.73	142.09	152.95	144.42	143.97	177.09

*/ By using the Wholesale Price Index of Machinery & Transport Equipment(Base 1970-71 = 100). The index for the years in question is as follows:

	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77
Index	105	112	123	156	173	170

Source for basic data (lines1 and 2): RBI Bulletins.

TABLE II

Profits of Central Government Public Enterprises under Historic Cost Accounting and Current Cost Accounting (Running production enterprises)

(Rs. crores)

	1974-75	1975-76	1976-77
1. W.D.V. of Fixed Assets	2896.63	3212.56	4323.17
2. Depreciation Provision of the year	255.70	279.36	316.15
3. Line 2 as percentage of line 1	8.83	8.70	7.31
4. Adjusted value of Fixed Assets (line 1 adjusted for price change*)	4518.74	5557.73	7349.39
5. Depreciation on adjusted W.D.V. (Line 4 x Line 3)	399.00	483.52	537.24
6. Depreciation adjustment (Line 5 minus line 2)	143.30	204.16	221.09
7. Profit after tax (HCA)	254.20	80.34	147.06
8. CCA profit(with only depreciation adjustment) (Line 7 minus line 6)	110.90	(-)123.82	(-)74.03
9. Dividends declared	13.77	15.69	40.46

* Wholesale Price Index of Machinery & Transport Equipment (Base 1970-71 = 100)

Source of basic data: Annual Report on the Working of Industrial and Commercial Undertakings of the Central Government (1976-77)

three years respectively. Clearly, the revenues of the Government's production enterprises were inadequate to cover their costs and HCA profits presented a misleading picture of the reality to the community.

1.23. It is to be added that the CCA profits presented in Tables I and II are derived by adjusting the depreciation of all fixed assets including buildings (figures of depreciation of buildings are not available separately). Since buildings do not depreciate as fast as machinery, the depreciation adjustments may have been on the high side. On the other hand, it is assumed that all machinery were of 1970-71 vintage (as 1970-71 was taken as the base for change in asset price adjustment). Since in the case of non-government companies, the bulk of the machinery is of older vintage, the depreciation adjustments worked out in Table I is in all probability an underestimate. Besides, no adjustment has been made for change in the cost of materials used in production. Thus, the profits which would emerge on a more comprehensive inflation accounting would be even lower than the figures given in Tables I and II.

1.24. It is sometimes contended that there is no need for going in for CCA to provide funds for replacement of assets since depreciation funds provided on the basis of HCA should be adequate for purposes of replacement even under conditions of inflation. For, it is argued, if the depreciation provision is invested either inside or outside the firm, it should normally achieve a reasonable rate of

return. If this return is taken into account, the value of the cumulative depreciation provision should provide funds for replacement of assets at an increased However, as pointed out by the Sandilands Committee, such an increase in the depreciation provision may still not close the gap. For instance, take a case where the annual depreciation provision are created on the straightline method for replacement of an asset with a life of 10 years acquired at a cost of Rs.10,000 and the price of the asset increases at the rate of 10 per cent per year. If the depreciation funds so available are invested internally or externally at an average after-tax rate of return of 10 per cent the cumulative amount of depreciation fund will increase at the end of 10 years, from Rs.10,000 to Rs.15,900, still leaving a gap of Rs.10,000 to be met when the asset is replaced. The gap will be Rs.24600, if the rate of inflation is 15 per cent per annum and Rs. 46,000, if inflation takes place at the rate of 20 per cent as the following table would show:

Shortfall in accumulated depreciation provisions made on HC& basis compared with amounts needed to replace an asset purchased for Rs. 10,000

(Figures in Rs.)

	Rate of Inflation per year		
	10%	15%	20%
Price of the asset after 10 years	25,900	40,500	61,900
Cumulative depreciation on historic cost basis(allowing for return on depreciation fund at 10 per cent per annum)	15,900	15,900	15,900
Shortfall	10,000	24,600	46,000

(Adapted from Sandilands Committee Report p.81).

1.25. It is also to be noted that the accretion to a depreciation fund from internal investment made by a firm in other assets may not lead to an increase at a uniform rate. As the Sandilands Committee observes:

> " The notional allocation of the depreciation provision to different internal 'investments' can only be arrived at by fairly arbitrary conventions. In addition, to the extent that an investment in monetary assets is assumed to have been made, account must be taken of the fact that the value of monetary assets such as cash and debtors cannot increase in terms of monetary units. An appropriate charge would therefore have to be made in the profit and loss account to reflect the fall in 'purchasing power' of monetary assets held by the company." (para 482, p.146).

1.26. In any case it would be unrealistic to assume that rate of return on the internal investment of depreciation funds can ordinarily keep pace with the rate of inflation after allowing for taxes and other demands likely to be made thereon. For any return on the investment of depreciation funds would normally go into the profits of the concern and thus get depleted not only by taxation but also by distribution in the form of bonus and dividend. For all these reasons the argument that investment of a depreciation fund should normally suffice to take care of inflation is not acceptable and was in fact rejected by the Sandilands Committee.

1.27. It is to be noted that in recognition of the possibility of depreciation fund based on historical cost being insufficient for replacement, nationalised industries in U.K. were advised even in 1967 to make provision for "the difference between depreciation at historic cost and

replacement cost and make allocations to reserve sufficient to make some contribution towards the industry's future capital development programme (which would otherwise fall on the Exchequer) and as a safeguard against premature obsolescence and similar contingencies.[23]

1.28. It is also relevant to note here that the High Powered Expert Group on Companies and MRTP Acts which included some eminent members of the accounting profession of the country also felt that in view of the rising trend of price levels in the past few decades all over the world "providing depreciation on historical cost will not be adequate to replace an asset when it becomes old or obsolete." The Committee has recommended that "a provision should be made requiring the companies to set aside 10 per cent of their profits after tax as a Replacement Reserve, provided that such reserve should be treated on par with depreciation under the statutes of the country" (Para 8.33 of the Report).

1.29. The possibility that inflation accounting may lead to an upward revision of product prices cannot be held out as an argument for continuing with historical costs. Inflation can not be kept in check simply by fixing prices of products below their costs. If the price of a product is inadequate to cover its cost of production the supply of the article cannot be maintained unless its production is subsidised by Government. When prices fail to cover costs, private producers cannot continue in business indefinitely and if the supply is to be maintained, Government has to take over the responsibility for

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23. Nationalised Industries: A Review of Economic and Financial Objectives (Presented to Parliament by the Chancellor of the Exchequer in Nov. 1967).

production. In the case of public sector undertakings, underpricing of the product leads to losses, which, when borne by the Government, imply a hidden subsidy from the exchequer. While there can be no objection to subsidies being given for the production of certain commodities or services, there is a limit beyond which subsidies cannot be provided. Besides, for a proper allocation of resources and also for an equitable distribution of the benefits of Government subsidies, it is essential to have a reliable idea of the quantum of subsidy in each case. If the subsidies represented by the losses of public enterprises are to be fully brought out, HCA is inadequate. The assumption that inflation can be kept under control simply by fixing prices of products below the cost of production is thus unsound and ignores the adverse impact of such pricing on the supply side. It may be noted that the implications of CCA for the rate of inflation were gone into by the Sandilands Committee and the Committee concluded that CCA may lead some companies to seek to raise prices, but will not alter the underlying position of a company, and at worst is unlikely

to advance by more than a few months any realisation that its profitability is too low. The extent to which a company can in practice raise prices will depend on market and legal considerations. Brazil's experience with inflation accounting also seems to show that CCA of unlikely to add to inflationary pressures significantly.[24]

1.30. From the angle of equity too it can be argued that current operating profit or CCA profit is more suitable than HCA profit as the base for income taxation since incomes of wage and salary earners are taxed in current terms.[25] No doubt, ideally, if equity is to be achieved all incomes should be indexed. Indexation can however be either automatic or discretionary. The increase in exemption limits and the allowances or deduction for cost of earning (e.g. the standard deduction or the deduction for saving) has had the effect of partial indexation. In any case, as stressed by the Australian Committee on Inflation and Taxation, the overriding test which any system of business taxation has to meet is the test of "compatibility of the tax system with the

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24. Sandilands Committee Report, Chapters 18 & 19.
25. Parker & Harcourt, op.cit. p.25.

maintenance of financial stability in the business sector, with continuity of business investment and activity, in short with business survival".[26] Both theoretical and empirical evidence seem to show that the business tax system based on historical cost profits may not pass this test under conditions of rapid inflation.

1.31 The apprehension that Government's tax revenues may register a sharp drop if CCA profits (assuming that adjustments for monetary itemsalso are carried out) were adopted as the base for taxation of business income may not be entirely justified. For, although under inflation adjustments for depreciation and cost of sales reduce the profits of firms, gains accruing to a firm from the decline in the real value of its liabilities tend to neutralise the downward revision of the profit figures at least in the case of firms with excess of monetary liabilities over monetary assets. Logically, if CCA profits are to be adopted as the tax base, adjustment for monetary items too should be carried out. A study of thirty leading U.S. industrial companies by Davidson and Weil shows that whereas price level adjusted profits form about 64 per cent of their reported income without adjustment for gain or loss on monetary items, when such adjustment for monetary items is made the profits go up to about 99 per cent of the reported net income. The median of adjusted net income as a percentage of net income for the said companies is 89 per cent.[27]

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26. Report of the Committee of Inquiry into Inflation and Taxation, op. cit.
27. "Inflation Accounting, Implications of the FASB Proposals" by Sidney Davidson and Roman L. Weil in Inflation and the Income Tax edited by Henry J. Aaron (Brookings Institution, Washington, 1976).

1.32 The study by Davidson and Weil sought to examine the impact of proposals for general price level adjustment and not adjustment for current cost of the assets. Recently published figures of CCA profits of some British companies show that with adjustment for current cost, profits may get reduced by as much as 79 per cent of the HCA profits for some companies, though in most cases the reduction is less than 50 per cent.[28] (This takes no account of the gain from monetary items). Thus adoption of CCA profits as the tax base would probably lead to an immediate drop in Government tax revenue, though its extent may not be as large as is often assumed. The loss in Government's revenue would however be made up by the saving of public funds which would result from a reduction in the dependence of business enterprises on financial institutions which are mostly in the Government sector In any event, it is becoming increasingly clear that if industrial enterprises are to survive and continue their operation, adequate allowance needs to be made for the rising cost of assets used up while measuring their surpluses. The assumption that funds can be borrowed to any extent overlooks the risk of financial instability which excessive reliance on borrowed capital entails.

1.33 Another point that needs to be emphasised in this context is that so far as public sector enterprises are concerned, the distinction between borrowed capital and equity has no relevance as the funds for both come mainly from the Government. Therefore, if adequate provision is not made out of current profits for maintaining their assets, the funds

28. "Inflation Accounting" by Michael Lafferty, Financial Times January 16, 1978.

for keeping them running have to come continuously from the exchequer. Failure to maintain the assets of public enterprises out of the current profits implies consumption of capital by the community. Hence introduction of CCA for such enterprises is of considerable urgency. Even when the earnings are insufficient to meet the costs, CCA would help a better assessment of the flow of funds within the community and bring out the distortions in the allocation of resources which otherwise go unnoticed.

Conclusion

1.34 Interests of long-run stability of busines enterprises argue for introduction of inflation accounting. Expert opinion seems to be crystallizing in favour of abandoning or at least supplementing HCA and adoption of some form of inflation accounting. Arguments put forward so long in favour of ~~akam~~ HCA are no longer considered convincing. There is a move in almost all English speaking countries to change over to CCA sooner or later. The only factor which appears to have held up progress in this direction is the lack of unanimity about the choice of a suitable alternative to HCA. As the discussion in the next chapter would show, the debate over the alternative to HCA is also settling down in favour of one among several alternatives and indications are that inflation accounting will find wider official recognition before long.

CHAPTER 2

ALTERNATIVE APPROACHES TO INFLATION ACCOUNTING

Alternatives to Historical Cost Accounting

2.1 Accounting for price changes can be carried out principally in two ways, viz. (i) by adjusting historical costs with a general price index, referred to hereafter as Current Purchasing Power or CPP accounting (also described in the literature as "General Price Level Adjusted Accounting" or simply as "General Price Level Accounting"); or (ii) by adjusting historical cost of individual assets either by separate re-appraisal of every asset or by adjusting the historical costs with a specific index for the asset group hereafter referred to as Current Cost Accounting or CCA (also called by some as Current value Accounting or Current Replacement Value Accounting). A combination of the two is also advocated by many as the ideal method.

2.2 Adjustments for general price level change facilitate statement of accounting in terms of money units of constant value in real terms while adjustments for specific price level changes serve to ensure maintenance of physical capacity of a business. The following diagram brings out the differences in the approach underlying the alternatives described above and their inter-relationship.[1]

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1. This diagram is an adaptation from Paul Resenfield's idea put forward in "The Confusion between General Price Level Restatement and Current Value Accounting" in Journal of Accountancy, October 1972 as presented in "Inflation Accounting - The Great Controversy" by Richard F. Vancil in Harvard Business Review. March-April, 1976.

Four Methods of Measurement

Unit of measurement	Method of asset valuation: Acquisition cost	Method of asset valuation: Replacement value
Nominal money unit	GAAP (Generally accepted accounting principles i.e. historical cost accounting or HCA)	CRVA (Current replacement value accounting i.e., current cost accounting or CCA)
Constant money unit	GPLA (General price-level accounting i.e. current purchasing power or CPP accounting)	SPLA (Specific and general price-level accounting)

2.3 The early proposals for inflation accounting emanating from the leading accounting bodies suggested the adoption of some form of CPP accounting in order to correct the deficiencies of HCA. Thus the Accounting Standards Steering Committee of U.K. had proposed in 1973 the adoption of CPP. F.A.S.B. of U.S.A. too had recommended only General Price Level Accounting in 1974. The Sandilands Committee, however,

found it wanting in several respects and favoured instead the adoption of CCA for purposes of inflation accounting. As noted earlier, a Steering Group was formed in the wake of the Sandilands Committee to formulate proposals to implement the ideas of the Sandilands Committee. The proposals drafted by the Steering Group were considered too complicated and found unacceptable by the majority of the main body of accounting profession in England. Finally the quoted companies in U.K. have been advised to follow a simplified procedure on current cost accounting as indicated in the guidelines of the Group headed by William Hyde. In U.S.A. too opinion seems to be veering round CCA and away from CPP. CCA however has its drawbacks and is yet to gain universal or unqualified acceptance of experts as may be seen from the cogently argued criticism of Prof. Baxter[2], the well-known authority on accounting. Before going into the criticism of CCA, considerations which seem to have weighed with various expert bodies to shy away from CPP may be noted.

Current Purchasing Power(CPP) Accounting V. Current Cost Accounting(CCA)

2.4 While the CPP provides a simple and objective way of converting monetary units of varying real values into a common measuring unit reflecting a uniform amount of general purchasing power, it is based on the assumption that a general index of price can reflect changes in general purchasing power. The fundamental objection of the Sandilands Committee

2. "Accountants and Inflation" by W.T. Baxter, Lloyds Bank Review, Oct. 1977. A review article on "Inflation Accounting" by J.A. Kay in the Economic Journal, June, 1977 also contains an incisive criticism of CCA.

against the CPP is that the concept of "general price change" in abstract unrelated to the purchasing pattern of any class of individuals or entities is unquantifiable. The rationale underlying CPP is based on the assumption that inflation implies an upward movement in the average price level of goods and services or, conversely, downward movement in the average purchasing power. The Sandilands Committee is sceptical of the use of the concept of average price level or average purchasing power. According to the Committee, these average movements in practice are only meaningful in respect of specific situations. To quote what the Committee has observed on the point:

> "There is no meaningful way of measuring either the average changes in prices of goods and services or the average change in the 'purchasing power' of money independently of a knowledge of the items whose prices are to be measured and of the purchasing pattern of the group of individuals or entities from whose point of view the movement in prices is being measured. Inflation does not exist as a quantifiable phenomenon independent of the price movement in any specific group of goods and services or of the spending pattern of any specific group of individuals or entities and is not a phenomenon capable of independent and objective measurement, affecting all individuals and entities in the same way. The rate of inflation will vary for different individuals and entities in the country according to the selection of goods and services which they buy". (para 45 of the Report).

2.5 Referring to the retail price index as a measure of the average purchasing power the Committee said that "it is unlikely to represent the rate of inflation experienced by companies the content or pattern of whose spending is not reflected, even approximately, in the calculation of the index". The Committee accordingly concluded that the concept of current purchasing power unit is of no practical use and therefore one has to think of current cost of individual assets.

2.6 A similar view also underlies the criticism expressed by some opponents of CPP that businesses do not experience general inflation; they are affected by particular increases in their operating costs and plant expenditure. The national weighted average of these increases, it is argued, may in some sense measure general inflation, but some businesses are affected much more severely than others. Thus adjustment of the historical cost of plants with a general rate in order to calculate a "better" figure of depreciation would rarely result in a number that will coincide with the current cost of replacing a plant. Hence, it is contended, CPP profits reflect neither historical cost nor replacement value. Yet another view is that "an historical cost remains an historical cost even when it has been adjusted by a general price index. It does not represent a current valuation".[3] The seriousness of the shortcoming of the CPP from this angle is underscored by the fact that prices of particular goods often differ markedly from the movements in the general price level.

2.7 Another criticism of the CPP is that it would require adjustment of monetary liabilities with a general price index and this might result in "monetary gain" from outstanding long-term debts, which, if recorded, would present a misleading picture of the financial position of the concern. It is argued that the gain should not be recognised until it is actually realised by reducing the debt.

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3. Readings in the Concept & Measurement of Income edited by Parker and Harcourt, Introduction, p.13.

2.8 The above deficiencies of the CPP, it is contended by its opponents, are removed by the CCA. CCA achieves this by, firstly, laying down that the cost of assets used in business are charged realistically and, secondly, by facilitating the separation of gains arising from price rise (the "holding gains") from operating profits. Determination of profits in this way enables the concerns not only to evaluate managerial performance but also to recoup enough from the current earnings to keep the business running at its existing level of operation. To keep the concern going it is essential to maintain its physical capital and this is helped more by CCA than by CPP.

Deficiencies of CCA

2.9 As pointed out by Baxter, the choice between CPP and CCA depends crucially on the question, whether, in measuring profit as the surplus left after "the firm's substance" has been maintained, one seeks to maintain real capital (i.e. money capital adjusted for inflation, in other words, the owners' ability to buy things in general as measured with a general index) or physical capital, that is, the firm's physical assets (e.g. tonnes of stock, number of similar machines etc.). CPP seeks to maintain the former i.e. real capital while CCA, the latter i.e. physical capital.

2.10 The case for CPP derives its strength from the argument that -

> "If we grant the importance of investors and owners we are impelled to view capital maintenance in the light of their personal welfare(purchasing power in the general market), not the physical size of the firm. CPP respects human beings rather than the 'demand abstraction' of the company". (Baxter, op. cit.).

By splitting up the accounting profit into "operating profit" and "realised holding gain", the proposals of Sandilands (and thus the protagonists of CCA) serve to make the former the centre-piece of the profit and loss account and the latter "a mere after-thought in an appropriate section of the account (a section which recent practice has tended to demote)".

2.11 The essential point of this criticism is brought out by the following example. If the cost price of an input is Rs.100 at purchase date and Rs.120 at date of sale and if it is sold for Rs.130, historical accounting profit would be Rs.30, but under CCA it will be split up into holding gain of Rs.20 and operating profit of Rs.10 and it is the profit of Rs.10 only which CCA commends as useful to managers, investors, trade unions and for taxation. It may be seen that under CCA, the key figure of input cost (Rs.120) is linked, not to the owners' welfare, but to the price of a physical replacement. Baxter ridicules the logic underlying this approach by comparing it with the practices of a primitive tribe "that rank a man by the number of his cattle, with no regard to whether the beasts are healthy or too decrepit to yield milk and meat". The profit figures, argues Baxter, are more informative if linked with values rather than quantities.

2.12 The point made above becomes all the more clear when values decline. If, for instance, in the example cited above, the current price of the input (whose original cost was Rs.100) falls to Rs.80, CCA profit and loss account would show an improvement in operating profit as may be seen from the following:

	HCA	CCA
P & L account		
Sales	130	130
Cost of input:		
Historical	100	
Current		80
Profit:		
Accounting	30	
Operating		50
Appropriation Section:		
Holding loss		(20)

Thus the CCA operating profit will, Baxter points out, generate optimism at a time when owners should exercise caution and taxation should be mild.

2.13 Kay goes further and argues that CCA operating profit as contemplated in ED 18 is not a measure of profit but only a measure of cash flow.[4] By itself, according to him, CCA profit may not be a good indicator of company profitability or distributable earnings. A liquidity measure of this kind, Kay agrees, may be of some use. A firm which has a high current cost profit may not go broke rapidly. But, the disadvantage of such a measure is, Kay goes on to point out, that "it is entirely backward looking". Profitability, unlike cash flow, tries to look forward to the effect of last year's experience on future activities. Hence a firm with a high CCA profit may not be going bankrupt quickly, but it may well be going bankrupt slowly. Hence, Kay suggests, statements of CCA profit might be usefully supplemented by some more forward looking indicators which bear a closer relationship to traditional notions of profitability.

4. "Inflation Accounting", J.A. Kay, Economic Journal, June 1977.

2.14 According to Baxter, the Sandilands Committee's main criticism of the CPP, viz. that the concept of general price changes is unquantifiable, is untenable. After all, price indices of a general nature are used for many purposes e.g. for national income statistics. To quote Baxter again;

> "Admittedly the retail price index does not reflect precisely the consumpton patterns of wealthy shareholders; but the divergence does not seem to be big. No system of inflation accounting will be perfect, and correction of income by a general index seems the least bad of the possibilities".

2.15 Another merit of the CPP is that it is simple and objective. It can ensure uniformity as the same index can be used by all firms. Also, as Brazil's experience shows, in practice, CPP has also the extra merit of letting us measure real gain, defined as gain in excess of that due to inflation. Thus, where there is a rise in the general index from say 100 to 114 on the sale of an article whose cost was Rs.100, there can be a real gain only if the sale money exceeds Rs.114. If it is sold for Rs.130, the real gain will be Rs.16. Under CCA, if the replacement value of the article is Rs.20, the operating profit is Rs.10, while the holding gain is Rs.20.

2.16 Despite its deficiencies as a measure of welfare, CCA continues to draw wide support and seems to be gaining ground among accountants and business executives as well as economists.[5] As mentioned earlier, in U.K. inspite of

5. See for instance the Introduction by Parker & Harcourt in the Readings in the Concept and Measurement of Income.

reservations on the part of some like Baxter, the opinion of accounting bodies seems to have moved away from CPP and crystallized in favour of some form of CCA. In U.S.A. too the trend seems to be in favour of CCA. The main reason underlying this trend is that for concerns which are committed to a particular line of activity, (e.g. a steel manufacturing company), CPP profit may not be appropriate for measuring earnings performance or what could be regarded as the quantum of "repeatable profits". And because it (i.e. CPP profit) "does measure current (opportunity) costs, it does not measure the economically significant factors in decision making."[6] As the president of a British Company (Wedgewood Ltd.) said while referring to the earlier recommendations of the English accounting institute for publication of general price level adjusted financial statements:

> "The result of using the retail price index to adjust a widely varying range of revenue and capital items in difergent industries in different parts of the country over widely extended periods of time will provide no sensible basis of comparative performance. Any investment analyst who forms a view of Wedgewood from these statements will almost certainly arrive at a misleading verdict".7

2.17 The need for CCA despite its operational difficulties is explained clearly in the following observations of the American Accounting Association Committee on Concepts and Standards - Long-Lived Assets:

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6. Inflation Accounting by Sidney Davidson, Clyde P. Stickney and Roman L. Weil(McGraw-Hill, 1976).
7. Quoted in Inflation Accounting by Davidson et.al.

> "Income from ordinary operations should represent an amount, in current dollars, which, in the absence of catastrophic loss or discovery of assets is available for distribution outside the firm without contraction of the level of its operating capacity; or, stated in another way, the amount which, by retention, is available for expansion of operating capacity. Measurement of this concept of income from ordinary operations can be accomplished only if the expiration of service potential is measured in terms of current cost. That is, in order to continue operations without contracting the level of operating capacity, exhausted services must be restored; the relevant cost of expired services is the current cost of restoration. For example, a firm may maintain some level of basic raw material inventory in order to continue operations at a given level. In the measurement of income from ordinary operations, the relevant expired cost when that material is utilised is the cost of replenishing the inventory. The number of dollars paid sometime in the past for the particular units of material used in this period is not relevant.
>
> The idential concept applies to depreciation: that is, depreciation must be based on the current cost of restoring the service potential consumed during the period. The measurement problems are greater in the case of depreciation however. The physical exhaustion of inventories is subject to actual count or weight, the expiration of the intangible service emanating from plant assets is subject only to rough, subjective evaluation. In addition, the determination of current cost may be more easily accomplished for inventories than for plant assets. Despite those measurement problems, the conceptual need for current cost depreciation in the determination of income from ordinary operations cannot be denied."8

Even Baxter concedes that though it leads to a faulty figure for profits, the CCA income statement gets good marks for showing costs realistically.

2.18 The preceding discussion would Show that CCA has the merit of ensuring maintenance of physical capacity and so is preferable in the case of a company committed to its

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8. Committee on Concepts and Standards - Long-lived Assets, "Accounting for Land, Buildings, and Equipment", Accounting Review, July 1964.

current line of business. If, for instance, the company is in steel business, and intends to stay in it, the capital put in the business should be measured in physical terms. For such a business if it is .. to keep going, profit should be measured in units of purchasing power that are generated in excess of those units required to maintain current productive capacity. Holding gains of such companies should not be available for distribution to shareholders.[9] This applies *a fortiori* to undertakings like Railways and State Electricity Boards in India.

2.19 The distinction between operating profit and holding gain and exclusion of holding gains in evaluating operating performance can also be justified on the ground that without the exclusion of holding gains, two managers operating plants with identical capacity but purchased at different times would otherwise have the same depreciation charges. Secondly, the holding gain is the result of the original investment decision, not of a subsequent operating decision; combining the two sources of profit would confuse the evaluation of the operating manager. For all these reasons CCA would seem to be superior to CPP. The suggestion that CCA profit should be supplemented by some conventional profit statement as CCA is backward looking is valuable but this does not weaken the case for CCA. Accounting on the basis of current cost may not be sufficient to prevent a firm from going broke slowly - but it is necessary to prevent the firm from going sick.

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9. Richard F. Vancil, *op. cit.*

2.20 The criticism that a portion of the holding gain may not be real can be taken care of and yet the merit of CCA retained if inflation accounting is done through a method which incorporates both specific replacement values on physical assets and adjustments for changes in the general price level. It is accepted by many[10] that a blending of the two (CPP&CCA) would provide the ideal method. Under such a method only the real holding gain (i.e. the gain arising from a rise in the price of the asset corrected for general price level change) would be credited. This method would however be complicated and give rise to immense practical problems. After surveying the literature and considering the merits and drawbacks of the rival system, Davidson and others come to the following conclusion:

> "Accounting that incorporates both current values and price level changes, is, in our opinion, the best solution to the problem of accounting for changing prices. Such accounting reports holding gains and losses on all assets and the recognition of gain or loss on holdings of monetary items. It is, however, both hard to explain and hard to audit, and is unlikely to receive much acceptance in practice in the foreseable future".11

Conclusion

2.21 Although the suggestions towards inflation accounting put forward by professional accounting bodies in U.K., U.S.A. and elsewhere initially favoured the CPP approach, in the

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10. e.g. Baxter, Vancil, S. Davidson, op cit.

11. Davidson et. al, op. cit., p.226

recommendations put forward more recently, choice has gone in favour of CCA. CCA alone, it is felt, can help ensure the maintenance of the physical capital of business firms. Hence, if businesses are to keep going, profits should be measured on the CCA basis. Though CCA has its shortcomings, in removing the main deficiencies of HCA, CCA is thought to be more appropriate.

CHAPTER 3

CURRENT COST ACCOUNTING - BASIC FEATURES AND PROBLEMS

3.1 An authoritative statement of the basic features of Current Cost Accounting (CCA) is available in the Exposure Draft 18 which was drawn up by the Inflation Accounting Steering Group set up by the accounting profession in U.K. in response to the Sandilands Committee's recommendations to coordinate the introduction of CCA. The Exposure Draft was endorsed by the Accounting Standards Committee. Detailed guidelines on the accounting procedures required by the accounting standard which was proposed in ED 18 are available in the Guidance Manual on Current Cost Accounting which was published on behalf of the Steering Group. Problems which arise in the implementation of CCA are also discussed in another publication of the Steering Group - the Background Papers to the Exposure Draft on CCA. Although the proposals of ED 18 were regarded as complex and its mandatory introduction was voted down by the members of the leading accounting body of England, these publications will remain the standard reference books on CCA for a long time to come. The CCA computations of BHEL also were based on these guidelines. It would therefore be useful to go over the main features of CCA as proposed in ED 18 and the alternative proposals contained in the Hyde guidelines issued in November 1977 and consider how far it would be practicable to adopt them in India.

ED 18 proposals in outline

3.2 The inadequacies of HCA which CCA seeks to remedy may be summed up as follows:

(i) HCA profit exaggerates growth as it makes no allowance for the fall in value of the money unit used to measure the results; and

(ii) its uncritical use may lead to the situation where capital, although maintained in money terms, may not be maintained in real terms and may be distributed to shareholders, employees, consumers or in taxes to the detriment of the long-term viability of the concern.

3.3 CCA seeks to remove the above deficiencies of HCA by laying down a system of accounting where realistic costs are charged against revenue. CCA as proposed in ED 18 would attempt to meet the main deficiencies of HCA in the following way:[1]

(a) Fixed assets would be shown in the balance sheet at their value to the business and not at their depreciated original cost; stocks would be shown in the balance sheet at their value to the business and not at the lower of their original cost and net realisable value.

(b) Depreciation for the year would be calculated on the value to the business of the fixed assets used up.

(c) The cost of stock consumed would be calculated on the value to the business of the stock as at the time of consumption.

(d) Any excess of the value to the business of the assets concerned would be credited to a revaluation reserve/surplus account.

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1. Guidance Manual on Current Cost Accounting (published on behalf of Inflation Accounting Steering Group; Tolley, 1976), pp.4-5.

(e) Directors could appropriate to a revaluation reserve amounts required to maintain the scale of the business. The main components of this appropriation were expected to be the following:

(i) increased replacement cost of fixed assets and stock;

(ii) increased requirements for monetary working capital; and

(iii) depreciation underprovided in the past on fixed assets because prices have risen since the depreciation was provided.

3.4 Annual accounts to be prepared and presented on the basis proposed in ED 18 contemplated, (i) a profit and loss account, (ii) appropriation account and (iii) a balance sheet. It was also suggested that, except for wholly owned subsidiaries, the notes to the accounts should include a statement of the change in the shareholders' net equity interest after allowing for the change in the value of money.

'Value to the business'.

3.5 The focus of CCA as contemplated in ED 18, it will be noted, was on two cost items viz. depreciation of fixed assets, and stock and work-in-progress consumed during the year. Under CCA both are to be charged on the basis of the 'value to the business' of the asset in question. 'Value to the business' is defined as "the amount the company would lose if it were deprived of the asset". While the value to the business of stock consumed during the year can be determined on the basis of prices prevailing in the market, several intractable problems arise in the valuation of fixed assets like plant and machinery.

3.6 The 'value to the business' of an asset, it was explained, is its written down current replacement cost or net replacement cost (NRC), that is, gross replacement cost less accumulated depreciation, except in situations where NRC is greater than both net realisable value (NRV) and economic value (EV). Where the NRV and EV exceed the NRC, the value of the asset to the business is NRV or EV whichever is greater. In most cases NRC would correctly represent the value of a fixed asset to a business.

3.7 The first step in the determination of NRC of an asset is to find out the Gross Replacement Cost (GRC). The manner in which this was to be determined was indicated separately for different categories of assets. Much of the difficulty of CCA stems from the problem of asset valuation. Where the asset in question is frequently traded, the GRC can be determined from the market rates. Where, however, the asset is infrequently bought and sold or where the same type of asset is no longer available, valuation has to be made on the basis of certain indicators and criteria. Valuation raises difficult problems particularly in the case of plant and machinery.

3.8 Gross current replacement cost of plant and machinery, it was stated in the Guidance Manual, is either (a) the cost to be incurred to obtain and instal at the date of the valuation of a substantially identical replacement in new condition or (b) the cost of a modern equivalent asset, whichever is lower. The cost of a modern equivalent asset is GRC of a modern piece of plant or

machinery adjusted by the present value of any material difference in operating costs,over its whole life, for material difference in output capacity,provided that any additional output is useable by the company,and for material difference in the total expected useful life of the modern machine compared with that of a substantially identical replacement.

3.9 A number of methods have been suggested for estimating the GRC of a substantially identical asset. The most usual methods are, in descending order of preference:

(i) Suppliers' official price lists.

(ii) The companies' own replacement cost estimated based on expert opinion.

(iii) An index compiled by the company from its own purchasing (or manufacturing) experience.

(iv) Authorised external price indices analysed by asset type.

(v) Authorised external price indices analysed by using industry.

The appropriate source of data in each case, it was stated, would depend on the circumstances. It was,however,added that whichever source of data is used, there must be a means of independently varifying the resulting GRCs.

3.10 Where the suppliers' price lists are available,the problem of determining GRC is relatively simple. Where, however, such lists are not available replacement cost would have to be estimated. Where the suppliers are selling only a modern equivalent asset, whose performance is similar to the existing asset, again the problem is somewhat simple, and the GRC would be lower of GRC of the modern equivalent asset

and the GRC of the existing asset. Where there is an alternative replacement which is not equivalent to the existing asset, it was indicated, a discounted value of any anticipated cost saving over the useful life of the alternative asset and of an amount to take account of any increased production should be deducted from the cost of the alternative asset to arrive at the GRC of a modern equivalent asset. For CCA purposes depreciation has to be calculated on the basis of an average depreciable value of the asset for the year. As indicated already, any increase in the GRC of an asset over the previously adopted value of the asset would be entered in a separate revaluation reserve/surplus account. Packlog depreciation i.e. accumulated depreciation on revaluation would be charged to the revaluation reserve/ surplus account.

Cost of material used

3.11 Regarding cost of material used, the ED 18 proposed that the profit and loss account should be charged with the current replacement cost of stock consumed. ED 18 did not require any particular method to be employed for this purpose. It was recognised that companies would need to develop the techniques appropriate to their business having regard to the nature of their operations and their stock and other relevant factors.

3.12 The appropriation account would show(a) the current cost profit or loss for the year, (b) the amount of surplus or deficit for the year and the amount appropriated by the directors from the revaluation reserve,(c) the dividends for the year and(d) the balance after transfer to or from general

reserve. This arrangement would reflect the rationale underlying the classification of total gains under (a) current operating profit and (b) holding gains.

3.13 As stated earlier, the ED 18 proposals did not find favour with the accountants in England and they voted against the adoption of the system being made compulsory. One of the reasons for this reaction was apparently that the proposals were too complicated. It was, however, felt by many that inflation accounting was necessary. This led to the setting up of the Hyde Group. Fresh and more modest proposals were drawn up by the Hyde Group. In their interim recommendations, the Hyde guidelines which were released by the Accounting Standards Committee in November 1977 contemplated that the published financial statements of listed companies should include a prominent separate statement showing financial results as amended by three adjustments, namely;

(i) depreciation
(ii) cost of sales
(iii) "gearing".

3.14 The guidelines indicated that the depreciation adjustment would be made for the difference between depreciation based upon the current cost of fixed assets and the depreciation charged in computing the historical cost result. An adjustment would also be made for the difference between the current cost of stock at the date of sale and the amount charged in computing the historical cost results.

3.15 A major shortcoming of the ED 18 proposals, it was pointed out by many, was that it did not provide for

adjustments for the gain or loss from monetary items(i.e. monetary assets and liabilities) being integrated with the other adjustments. In order to correct this deficiency the Hyde proposals suggest that adjustments may be made for the monetary items too. This is called the "gearing adjustment". Recognising that there are different views on how monetary items should be dealt with and that such differences are unlikely to be resolved soon, the Hyde Guidelines suggest that some adjustment for monetary items should be made as otherwise the accounts would present an incomplete and potentially misleading picture to shareholders and other users of accounts. The gearing adjustment a proposed by the Hyde Group has to be made in the following manner:

> Where the total liabilities including preference share capital exceeds the total monetary assets of the firm,a calculation should be made of the proportion of:
> (a) the net balance of monetary liabilities, to
> (b) the net balance of monetary liabilities plus the equity share capital and reserves. (including the revaluation reserves).

Under the Hyde method of CCA, an amount equal to this proportion of the depreciation and cost of sales adjustment will be credited as a separate adjustment in the statement.An outline of how the Hyde Guidelines would operate in practice is given in the Appendix to this Chapter.

3.16 The Hyde guidelines are much simpler than those of ED 18 and the initial reaction among accountants seems to be favourable. It appears that new inflation accounting proposals are being considered by senior members of the British accountancy profession which will go beyond the Hyde guidelines which large companies have been asked to follow during the entire period until acceptable inflation accounting standard can be developed.

As indicated earlier a new draft of CCA Standard which, initially, will be applicable to companies with turnover of more than £1m. is expected next spring and will come into operation from October 1979.[2]

CCA for Indian Companies

3.17 From the outline of the method of current cost accounting proposed in the Hyde guidelines given above, it would appear that the scheme is not impracticable. In fact, the Hyde guidelines were widely welcomed as more modest and much less difficult to follow than the ED 18 proposals. If the deficiencies of historical cost accounting are to be removed and industrial enterprises are to maintain their capital - and this is of some urgency in a country where the public sector owns a large part of the productive capital - it would seem eminently desirable to require Indian companies also to draw up financial statements on the CCA basis at least as a supplement to HCA statements. Large companies i.e. companies with fixed assets of more than Rs.1 crore and all public sector companies other than those engaged in trading activities may be subjected to this requirement.

3.18 Although prices in India have been stable for the last two years, the inflation that occurred during the first half of the seventies and the sharp rise in international prices of capital goods calls for a review of the accounting system which gives rise to the risk of capital being eaten away imperceptibly.

3.19 To start with, CCA accounting may be introduced only for the profit and loss account on the lines suggested by the Hyde Group. The disclosures of CCA profits made by BHEL in their annual report for the years 1975-76 and 1976-77 would show that the task is not beyond the resources of Indian companies. It may not be out of place to refer in this connection to some of the difficulties faced by BHEL in working out CCA profits and

2. Financial Times, September 19, 1978.

what could be done to facilitate the introduction of current cost accounting in India.

3.20 As was to be expected, the prime difficulty faced by BHEL in working out current operating profits on CCA principles was that for quite a few items of machinery used by the company exact replacements are not available. Due to fast changing technology the machines available now are either more sophisticated or are faster in their performance or employ a new technology resulting in greater efficiency and higher production levels. In such situations it was difficult to obtain either the replacement cost or the suppliers' price list for the existing machines. If the ED 18 suggestions were to be followed, the current value of substantially identical machines would need to be obtained from the price of a modern machine after adjusting for its greater efficiency and longer life. However, that would not be simple for the reason that it would call for estimating the economy in costs resulting from the greater efficiency of the new machine as compared to the old one and the discounted value of such economy.

3.21 An alternative method would be to use indices compiled by the company from its own purchase experience or by authorised external agencies. In U.K.,Government agencies bring out price index numbers for current cost accounting. It contains all the indices compiled by the

Government Statistical Service which are currently available as well as describe briefly how these are compiled. In India, the Economic Adviser in the Ministry of Industry brings out index numbers of wholesale prices regularly. One of the major groups covered by these index numbers is "Manufactured products". One sub-group of "Manufactured products" is "Machinery and Transport equipment." All machinery items covered by the "Wholesale Price Index" are comprised by this sub-group. Hence, the index numbers of prices of this sub-group as a whole and of individual items coming within it could perhaps be useful in obtaining the current values of many types of capital assets. Where a particular item of machinery used by a company does not come within the scope of the commodities listed in the sub-group referred to, the company may consider constructing index numbers of capital goods of its own on the basis of the quotations of prices of identical or "equivalent" assets. Similar indices may be constructed for the principal items of stock on the basis of available quotations. Alternatively, the price of major commodities used in the manufacture of the various items in the stocks (e.g. the price index of copper and aluminium in the case of large number of items used in BHEL) could be relied upon to build up the companies' own index numbers. Once it is decided to introduce CCA, suitable steps may be taken by the appropriate agencies for compiling index numbers which would facilitate its implementation.

3.22 Yet another alternative could be to suggest to industrial undertakings in the public sector(including those in the power and transport sector) and large industrial companies in the private sector to carry out inflation adjustments in their conventionally determined profits(i.e. HCA profits) by revising the value of fixed assets used in business on the basis of a single price index and charge depreciation accordingly. The wholesale price index for 'Machinery and transport equipment', which forms one of the sub-groups of the major group "Manufactured Products" may be used for this purpose. The implicit price deflator for capital formation used in national income statistics would also be appropriate. The cost of sales adjustment too may be carried out by taking the difference between the value of opening stocks at actual prices and the value of the same stock at the prices prevailing at the time of closing on the basis of actual stock schedules and price lists. While adjustment made in this way would not serve fully the objectives which a full fledged current cost accounting is designed to achieve, it would provide a good via media between CPP and CCA, and have the merit of simplicity. Since the same index would beused by all firms it would reduce the scope for subjectivity in the accounts. One can even argue that in some respects inflation accounting carried out with the help of a single price index like this would have the virtues of both CCA and CPP in that it would help industrial concerns to maintain their capital in the physical sense which is the main aim of CCA, if "capital" is interpreted to mean not the specific assets used in that particular undertaking but

capital goods in general. At the same time, it would provide a broad measure of the owners' welfare which is the chief merit of CPP. It may be noted that the Australian Committee on Inflation and Taxation also, while recommending the introduction of inflation accounting, suggested the use of a single index based on the implicit price deflator for gross private fixed capital expenditure in the Australian national accounts for indexing depreciation allowances.

CCA profit for taxation: the drawbacks

3.23 Introduction of CCA even in such a modest form as proposed in the Hyde Guidelines would give rise to demand for adoption of operating profits so computed as the base for taxation of business income. Although one of the principal objectives of CCA accounting is to ensure that the financial statements report only "true profits" so that real capital of business is preserved and not distributed away in the form of dividend, wages or taxes - and this aim would be largely frustrated if taxation continues to proceed on the basis of HCA - for several reasons a change-over from HCA to CCA for purposes of taxation does not seem to be possible or even necessary atleast for the present.

3.24 Firstly, the suitability of CCA profits as the base for taxation which seeks to tax people according to their ability to pay is open to question on the ground that the entire CCA approach is oriented towards maintenance of physical capital and does not provide a yardstick for measuring relative welfare or economic power of the

taxpayers. This criticism forms the core of Baxter's objection to CCA as compared to CPP referred to in the previous chapter.

3.25 According to another criticism, the "current cost profit" envisaged by the Sandilands Committee and as it emerges out of ED 18 proposals is not a measure of profit at all, but a measure of cash flow.[3] Liquidity of a firm, it is argued, is not identical with its profitability. Taxation if it is to be equitable, it is contended, should be based on a measure of profitability and not liquidity.

3.26 The above objection can be met by pointing out that equity is not the only objective in taxation. Moreover, in the taxation of entities like corporations, it is not very meaningful to look for equity and for such entities equity is of less relevance than other considerations of which the overriding one is, as stressed by the Australian Committee on Inflation and Taxation, the survival of the business. Therefor a cash-flow base for corporate taxation is preferable to a pure profitability base. It has to be recognised, however, that the choice of the base for corporation tax is linked closely to the base for personal taxation. A scheme of corporate taxation on the cash-flow base would perhaps be quite consistent with a system of personal taxation based on

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3. "Inflation Accounting" by J.A. Kay, Economic Journal, June, 1977.

expenditure as suggested by the Meade Committee.[4] Where income forms the principal base for personal taxation, if the cash flow concept of income is adopted as the corporation tax base, some way would have to be found for taxing the gains accruing to shareholders in the form of rising equity values resulting from accumulation of profits in companies. Besides, it also needs to be considered whether the gain to the companies arising from the rise in the value of the assets, which under CCA would be credited to a revaluation surplus account, should be left out of the tax base. When the general price level is stable and only the relative prices change, accretions to the revaluation surplus would represent real gain to the concern and there would be little justification for keeping them out of the ambit of taxation. In fact, Prof. Samuelson has suggested that in such situations businesses should be required to deduct the actual change in market value of depreciable assets in calculating the cost of goods sold.[5] Thus, for example, if the price of an asset with life of 5 years is 100 in 1977, on the straightline basis the depreciate value of the asset at the end of one year would be 80. But if the price of new asset of the same type goes up to 120 in 1978 its depreciated value after one year would be 96.

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4. The Structure and Reform of Direct Taxation, Report of a Committee chaired by J.E. Meade(Institute of Fiscal Studies, London 1978), Ch. 12

5. "Tax Deductibility of Economic Depreciation to insure Invariant Valuations" by P.A. Samuelson, Journal of Political Economy, December 1964.

Samuelson would permit a business using such an asset to charge depreciation of only 4 for the first year. In other words, under his formula accrued capital gain(of 20) would be set off against the higher depreciation charge(of 24). While this would be equitable, taxation of capital gains on the accrual basis would give rise to a host of problems.

3.27 Whether accrued capital gains are included in tax base or not, if CCA profits are to be adopted as the base, gains or losses arising from monetary items cannot be ignored. One of the grounds for attack on ED 18 was that it did not take the gain or loss on monetary items adequately into account. Of course ED 18 marked an improvement over the Sandilands proposals in that it provided for a note to the accounts to show how the long-term liabilities have changed and the net change in equity interest. But there was no proper itegration of gains on monetary items even under the ED 18 system. Pointing to this deficiency, banks wanted an amendment to the ED 18 in order that the losses they suffer from the decline in the real value of the assets in times of inflation- which in their case is money - are duly reflected in the CCA statement of profit or loss. But, as Baxter has cautioned, this is an area where one should tread warily. It may be asked, if banks get tax relief on net monetary items, why should not personal taxpayers also get similar benefit? And why should firms with large loans not pay tax on the resulting gains? The Hyde Guidelines take partial note of the problem created by monetary items by providing that the depreciation and cost of sales adjustment are to be reduced appropriately

if the monetary liabilities exceed the monetary assets. While this would serve to offset the reduction of the profits(as obtained in the conventional way) resulting from depreciation or cost of sales adjustment under CCA, the gain arising to business firms from a decline in the real value of liabilities would still be left out of the profits. The adoption of CCA profits as the tax base depends crucially on a satisfactory solution being found to this problem,viz. the treatment of gains and losses arising from monetary items.

3.28 The most serious difficulty in the adoption of CCA profits as the same for corporate taxation arises from the fact that until reliable external indices are available for valuation of all assets the profits worked out on CCA principles would have to rely largely on estimates of the value of assets to the business from time to time. Both the ED 18 as well as Hyde Guidelines leave room for large elements of subjectivity in the computation of profits. As might be seen from the earlier discussion, CCA calls for valuation of assets on a current basis and where technology is changing fast estimates by experts would be required. The subjective nature of CCA profit was recognised by the Sandilands Committee as well as the Morpeth Group. This would be evident from the following observations of the Sandlands Committee:

> "Profit for the year is a practical business concept used as a guide for prudent decision making by companies. It may usefully be defined as the amount of the total gains arising in the year that may prudently be regarded as distributable. It is thus a subjective concept, since inevitably there will be differences of opinion on how far gains arising in any given year may prudently be distributed. Gains

> that are legitimately regarded as profit by a company in a given set of circumstances might not be regarded as profit by another company operating in different circumstances".

Referring to the above observations, the Guidance Manual on CCA also said:

> "CCA recognises the subjective nature of the concept of profit outlined in this (i.e. the above) and accepts that no reasonably objective accounting system can arrive at a profit that will in all cases be regarded by the management as distributable."[6]

quotation

3.29 The freedom allowed under the Hyde Guidelines for businesses to adopt their own methods of computing current cost depreciation also leaves room for a wide degree of subjectivity in the computation of current cost profits. The Hyde Guidelines state - "Where a business has already developed appropriate methods of computing current cost depreciation it is recommended that such methods should be used for the purpose of computing the adjustment." It may be argued that even at present companies can follow their own system of accounting provided a particular method is adhered to consistently. There are, however, well-recognised standards which govern the accounting practices and thus serve to ensure a reasonable degree of uniformity. Until uniform or generally acceptable standards are evolved for CCA, it would not be appropriate to change over to current cost profits for purposes of taxation of business income.

3.30 It may be added that the existing tax system allows concessions which go to relieve the difficulties arising from historical cost accounting atleast to some extent e.g.

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[6] Guidance Manual, paras 1.30 & 1.31.

accelerated depreciation. Available studies show that accelerat. depreciation based on historical cost is worth about as much to firms as allowing depreciation based on replacement cost when the rise in prices is moderate (say, about 5 per cent a year).[7] In U.K. in order to relieve the liquidity problem arising from the rise in cost of material, the Government allowe. companies to reduce the closing valuation of their stocks and work-in-progress for the accounting period concerned by the amount of the increase during the year of their book value. As pointed out by the Sandilands Committee, this method has its limitations. However, in the absence of full-fledged CCA this has the effect of providing some relief to the companies. Pending further examination of the entire set of issues which arise for taxation, arrangements could be evolved in the Indian income-tax too to afford some relief from the burden caused by rising cost of material by permitting the use of LIFO accounting or the use of the base stock method.

3.31 The time is not yet ripe for any reform of the tax base for the corporation tax by business income of such a drastic nature as a change over to CCA would involve. In view of the stability of prices in India in the last few years, there is no reason to embark upon a major reform of the tax base immediately without considering all its implications.

3.32 It may be added, however, that the reform of the corporation tax towards a CCA base, if considered desirable otherwise, should not be held up merely for fear of loss of Government

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7. "Economic and Budgetary Effects of Indexing the Tax System" by Edward M. Graulich, in Inflation and Income-Tax edited by Henry J. Aaron.

revenue. The apprehension that a change-over from HCA to CCA for purposes of corporate taxation would lead to a sharp drop in Government revenues may not be wholly justified. For, as studies on the subject reveal, with CCA, while for some firms the taxable profit might go down, for some there might be a rise especially for those who rely heavily on borrowed funds. Besides, in India the loss in Government revenue, if any, from such a change would be compensated by a reduction in the demand for assistance from financial institutions whose funds too are provided largely by the exchequer.

3.33 The argument that it would be iniquitous to allow business income alone to be computed for tax purposes on the basis of CCA does not seem to be well founded. In fact, as pointed out by Parker and Harcourt, the existing practice whereby incomes of salary earners, and of companies in insurance, banking and finance, are measured in current terms, while HCA profit is the base for taxation of other business income is open to objection on equity grounds. Thus, on grounds of comparability, CCA profit is more suitable as a tax base. The merit of such a base is that, as Parker and Harcourt put it, -

> "The income of all classes of taxpayer would be measured in a similar way and the taxable incomes of manufacturing firms of the same technical nature and the same replacement costs would be the same. The present use of accounting profit as the base tends to favour new firms, firms which bought plant in periods of high prices and firms which spend more on repairs than replacement."[8]

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8. Parker & Harcourt, op cit p. 25.

3.34 However, adoption of CCA profit as the base for taxation has several implications which need further consideration. In view of this the present Study Group recommends adoption of CCA only to provide supplementary information for large companies and industrial undertakings in the public sector.

Conclusion

3.35 CCA may be introduced in India at least for the public sector industrial enterprises and private sector individual companies with fixed assets of more than Rs.1 crore. The simplified guidelines for CCA brought out by the Hyde Group in UK could provide a basis for a practicable system of CCA in India. To facilitate its introduction, arrangements may be made for compiling index numbers of prices of capital goods on as wide a range as possible. A simpler alternative would be to carry out adjustments for inflation accounting with the help of a single price index e.g. the wholesale price index for "Machinery and transport equipment" or the deflator used for estimating capital formation in the National Income Accounts. CCA profits however need not be adopted as a base for corporation tax for the present.

APPENDIX

THE HYDE GUIDELINES IN OUTLINE*

The guidelines recommend adjustments on two profit and loss account items:

(1) Cost of sales
(2) Depreciation

A further adjustment on monetary assets and liabilities in the balance sheet is also recommended, called the gearing adjustment.

Cost of sales

In the absence of appropriate methods of computing current cost of sales, the averaging method is recommended. (Where appropriate methods exist in companies for a current cost of sales adjustment, the recommendation need not apply). The steps involved in the adjustment are:

(1) To arrive at the historic cost of sales by adjusting purchases with the opening and closing stock;

(2) To revise opening and closing stock at historic values to average current cost, by the use of an appropriate index;

(3) To arrive at the current cost of sales by adjusting purchases in the year, which are a good approximation of the use to the business of such items, by the current cost opening and closing stock figures arrived at in (2) above;

(4) The difference between the current-cost cost of sales and the historic-cost cost of sales is the cost of sales adjustment.

A short-cut method of arriving at the cost of sales adjustment which does not require knowledge of purchases in the period, is given by the following formula:

$$\left(s_1 \frac{x_2}{x_1} - s_1\right) - \left(s_3 \frac{x_2}{x_3} - s_3\right)$$

Where x_1 represents index at start of period;
x_2 represents index average for the period;
x_3 represents index at end of period.

and s_1 represents the historic cost of opening stock
s_3 represents the historic cost of closing stock.

Use of the averaging method for cost of sales adjustment is shown in the example given in Exhibit I at the end of this appendix.

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* Adapted from "THE GOOD HYDE GUIDE" by A. CHANDIOK, ACA, The Accountant, London, January 19, 1978.

Using the figures in the illustration given in Exhibit I and by substituting in the formula above, we get

$$\left(350 \times \frac{110}{100} - 350 \right) - \left(540 \times \frac{110}{120} - 540 \right)$$

$$= (385-350) - (495 - 540) = £\ 80$$

The method recommended by Hyde clearly goes some way towards showing the effect of inflation on the increase in the value of goods sold over historic cost.

The adjustment however is on the conservative side and does not take account of the full effect of inflation being a mere 4 per cent on historic cost of sales (£ 80 ÷ £ 2,110/100) as against an index which shows an increase of 10 per cent.

Depreciation

Hyde recommends that the depreciation adjustment should be the difference between the revised current year depreciation charge and the historic cost depreciation charge, the former being arrived at after revaluing the asset by the use of an index.

A simple example illustrates:

Assume a machine is purchased on January Ist, 19x5 for £ 1,000. It is estimated to have a useful life of five years and no resale value at the end of the five years. Further assume an index at January Ist, 19x5 - 100; at Dec. 31st, 19x5 - 110; at December 31st, 19x6 - 120.

The depreciation adjustment can be arrived at from the table below:

Year	Value of asset at end of year	Annual depreciation rate	Current cost depreciation charge	Historic cost depreciation charge	Depreciation adjustment
	£	Per cent	£	£	£
1	1,100	20	220	200	20
2	1,200	20	240	200	40

The depreciation adjustment is the adjustment required for the profit and loss account of the year only. The adjustment does not require backlog depreciation to be ascertained. Because the adjustment calls for the difference between depreciation on current costs and historic costs of assets, it follows that assets will need to be analysed on the basis of the year of purchase.

Gearing

The old argument regarding the effect of net monetary assets or liabilities has been extended in the recommendations by the suggestion of a gearing adjustment. The gearing adjustment has the effect of reducing the cost of sales and depreciation adjustments if monetary liabilities exceed monetary assets - the argument being that if there is a balance of net monetary liabilities, then part of the investment in fixed assets and inventories is being financed by non-equity providers of finance. Therefore, the cost of sales and depreciation adjustments must be borne in part by such non-equity providers of finance, and accordingly, the adjustments charged in the profit and loss account need to be reduced.

The gearing adjustment (vide EXHIBIT II) requires the following steps:

(1) First ascertain the balance of net monetary liabilities - £ 456;

(2) Next, ascertain the proportion of net monetary liabilities to net monetary liabilities and shareholders' funds;

$$\frac{456}{1,140} \times 100 = 40 \text{ per cent;}$$

(3) Apply the proportion in (2) above to the sum of the depreciation and cost of sales adjustments - giving £ 60.

At the extreme, the gearing adjustment can have the following results:

(1) A company with 100 per cent debt-financing will show a zero cost of sales and depreciation adjustment; in other words the profit will be the same as the historic cost profit.

(2) Conversely, a 100 per cent equity-financed company will have the entire cost of sales and depreciation adjustments as a charge in its profit and loss account.

But the application of the gearing adjustment implies that the cost of sales, depreciation and the adjustment for net monetary liabilities are all subject to the same rate of inflation. This clearly need not be the case as the types of assets and liabilities range from liquid assets to fixed assets and both long and short-term financing are included.

On the question of net monetary assets, Hyde recommends an adjustment based on a suitable index. The following example illustrates:

Let £ 100 be the balance in the bank at the start of a year and at the end of that year, and let the index be 110 and 120 at the start and end of the same year respectively.

Then the adjustment for net monetary assets, shown as a charge in the profit and loss account, would be;

$$\left(\frac{120}{110} \times 100 \right) - 100$$

$$= 109 - 100 = £\ 9$$

Clearly, if a charge of £ 9 is produced when a balance of net monetary assets exists, then it should follow that a similar but opposite gain of £ 9 should arise if the balance was of net monetary liabilities in the same amount.

This will not happen however, under Hyde's gearing adjustment. However, recognising the possibility of such conflicts, the guidelines observe " that there are differing views on the question of how monetary items should be dealt with ....".

The Hyde group acknowledges that the guidelines (The Accountant, November 10th, 1977) are only a starter in the evolution of inflation accounting. The proposals are restricted to adjustments applying only to the profit and loss account. The adjustments recommended are meant to be included in a prominent separate statement in the financial statements of listed companies.

EXHIBIT I

Example of the use of the averaging method for calculation of the cost of sales adjustment

	£ '000
Historical cost data	
Opening stock	350
Add: purchases	2,300
	2,650
Deduct: Closing stock	540
Cost of sales (historical cost basis)	2,110
Index numbers for cost of stock	
Beginning of year	100
End of year	120
Average for year	110
1. Revise opening and closing stock to average current cost for the year	
Opening stocks £ 350,000 x $\frac{110}{100}$ =	385
Closing stocks £ 540,000 x $\frac{110}{120}$ =	495
2. Compute current cost of sales using the revised amounts for opening and closing stock	
Opening stock	385
Add: Purchases	2,300
	2,685
Deduct: Closing stock	495
Cost of sales (current cost basis)	2,190

3. Calculate cost of sales adjustment	£ '000
Cost of sales (current cost basis)	2,190
Deduct: Cost of sales (historical cost basis)	2,110
Cost of sales adjustment	80

EXHIBIT II

Illustration of the gearing adjustment

1. Total liabilities of the business exceed its total monetary assets, summarised balance sheet, after adjustment for the difference between the current values and historical cost amounts for fixed assets and, if material, for stocks:-

	£ '000
Equity share capital and reserves	684
Long term liabilities	350
Current liabilities	406
	1,440
Fixed assets	600
Stocks	540
Monetary assets	300
	1,440

(a) Calculate net balance of monetary liabilities

	£ '000
Long term liabilities	350
Current liabilities	406
Total liabilities	756
Deduct: Monetary assets	300
Net balance of monetary liabilities	456

(b) Calculate net balance of monetary liabilities plus the equity share capital and reserves

	£ '000
Net balance of monetary liabilities	456
Add: Equity share capital and reserves	684
	1,140

(c) Calculate gearing proportion

$$\frac{\text{Net balance of monetary liabilities divided by £ 456,000}}{\text{Net balance of monetary liabilities plus equity £1,140,000}} = 40\%$$

(d) Calculate gearing adjustment

	£ '000
Depreciation adjustment	70
Cost of sales adjustment	80
	150
Multiply by gearing proportion	40%
Gearing adjustment	£ 60

2. Total monetary assets of the business exceed its total liabilities. In this case, the net balance of monetary assets should be calculated as shown in 1(a) above. The adjustment should be calculated by multiplying the net balance of monetary assets by the percentage change in an appropriate index during the accounting year.

P A R T - II

(by Shri R. Rajagopalan,
Chief Cost and Accounts
Officer).

CHAPTER 4

THE RATIONALE UNDERLYING THE CHOICE OF HISTORICAL COST FOR MEASURING FINANCIAL PERFORMANCE OF BUSINESS ENTERPRISES

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FINANCIAL STATEMENTS AND THE CONCEPT OF GOING-CONCERN

4.1 The definition of 'financial statements' as set out in the Commentary on the Statements of International Accounting Standards is repeated here for convenience. They are the accounts or financial statements which are issued to the shareholders of a company or made available to the public, normally each year, and are usually the subject of a report by the auditors. The term covers Balance Sheets, Income Statements or Profit and Loss Accounts, and other Statements, and Notes and explanatory material which are identified as being part of the financial statements.

4.2 Financial statements give information which is used by a variety of users, especially owners and creditors (present and potential) and employees. Other important categories of users include suppliers, customers, trade unions, financial analysts, statisticians, economists, and taxing and regulatory authorities.

4.3 The users of financial statements require them as part of the information needed, among other purposes, for making evaluations and financial decisions. They cannot make reliable judgements on these matters unless the

financial statements clearly disclose the accounting policies which have been adopted in preparing them.

4.4 Certain fundamental accounting assumptions underlie the preparation of financial statements. They are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed, together with the reasons.

4.5 It is fundamental to the understanding and interpretation of financial statements that those who use them should be aware of the main assumptions on which they are based.

4.6 One of the fundamental accounting assumption is:

> The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

ASSET VALUATION CONCEPTS

4.7 The concepts relevant to financial statements measuring financial performance for the enterprise as a whole have been admirably dealt with by Dr. Walter B. MacFarland, Research Director, National Association of Accountants, New York (NAA), in the Book 'Concepts for Management Accounting' published by NAA. Some extracts from this book are reproduced below.

4.8 Capital possessed by a business entity has two aspects which are recognised by accounting. These aspects are its forms, termed assets, and equitable interests in it, termed equities. As used here, equities include both creditor and stockholder interests.

4.9 Two categories of assets are distinguished:

1. Financial assets, consisting of money and rights to receive ascertained number of dollars.

2. Non-financial assets, consisting of items posssessing service potentials for use in earning future recoveries.

In a manufacturing or merchandising enterprise financial assets represent capital in liquid form available or soon available for investment in operating assets, for distribution to suppliers of capital, or for paying taxes. For this reason, financial assets represent uncommitted capital. In contrast with financial assets, non-financial assets do not represent current funds. While the acquisition costs are known, the number of dollars to be received in exchange for services of these assets can only be estimated until the exchange transactions actually take place. Conversion of these assets into cash without replacement terminates the stream of future revenues and thus amounts to liquidation of the enterprise.

4.10 The financial asset concept is relevant for measuring liquidity. In reporting financial assets, no major alternatives are encountered in choosing relevant valuation concepts because these assets are expressed in current or near-current dollars. That present worth of receivables is lower than maturity amount can ordinarily be disregarded in a going company. Current payables are due in a short time and hence appraisal of liquid

condition does not require that short term financial assets be discounted to cash equivalent on the balance sheet date. On the other hand, where instalment receivables or other items do not mature within the period covered by suppliers' credit terms, liquidity is better measured by net present worth of financial assets.

4.11 Financial assets are, of course, subject to hazards which go with the possession of such assets (e.g., insolvency of debtors, theft) and the reported amounts are reduced by expected losses.

4.12 Unlike financial assets, the non-financial assets are not current funds stated in ascertained numbers of current dollars. Alternative valuation concepts exist and the accountant is faced with choosing a concept relevant to the intended use for the information. Moreover, assets in the non-financial group are not homogeneous and the considerations underlying a choice of valuation concepts do not affect all non-financial assets alike.

4.13 Three major alternatives are available in approaching the valuation of non-financial assets. The first approach looks to future outputs and derives valuation from cash flows expected to be received from sale or use of the assets. Basic data needed are future cash flows and the appropriate discount rate. Valuation proceeds by discounting future cash flows to their present worths. The second approach values individual input factors (i.e. non-financial assets) at prices current

on the balance sheet date. Current valuation may be either in the market where the assets owned could be disposed of or in the market where like assets could be acquired (i.e. in the replacement market). Data required are an inventory of non-financial assets on the balance sheet date and current market prices of these assets. The third approach values assets at historical acquisition cost less accumulated allowances for depreciation, depletion, and amortisation where the service potential represented by the respective assets declines with usage and passage of time. Data needed for this method are ordinarily available in the accounts.

4.14 The present worth of future cash flows from the enterprise is the valuation concept which is relevant for answering the question, "What is the business worth?". It is the current price which a buyer would pay to acquire the business, or to acquire an equity in it. The present worth concept of asset value is relevant for selling or buying assets or equities in assets. Since such valuations rest on forecasts of future profits and choices of capitalisation rates, the subjective character of the valuation process requires each individual to make his own appraisal. Owing to the highly subjective nature of these measurements, the method is generally rejected as not reliable enough to be useful for measuring financial position or income in periodic reports to shareholders.

Applications of the concept are usually made in some form during sale, purchase, or merger of a business. Such events are occasional in the lives of most companies and hence valuations of this type are undertaken only when there is specific need for the information.

4.15 The concept of current cost exists in three principal versions:

1. Historical costs restated in terms of the current purchasing power of money with the latter measured by an index of the general price level.

2. Current opportunity costs, that is, the values that could be realised if the assets were sold at the best prices presently obtainable.

3. Current replacement costs, or costs which would be incurred if the assets were acquired on the balance sheet date.

Restating non-financial assets in terms of the current purchasing power of money is analogous to converting a sum of money from pounds sterling to United States dollars or vice versa. The basic concept remains historical cost with the same assets merely being measured in monetary units having a different purchasing power. Hence, it is not really a current cost valuation method.

4.16 Opportunity costs are measured by current prices in the market where the company's assets might be disposed of. Current opportunity costs are relevant to proposals to replace or to dispose of assets. These decisions are made by management guided by data developed by special

studies rather than by repetitive reporting. Opportunity costs are irrelevant to investors who do not make such decisions.

4.17 In a going business, a large portion of the non-financial assets consists of equipment for use in manufacturing and merchandising goods. Much of this equipment is highly specialised in nature and the only alternative to continued use in the business is often to sell it at low prices as scrap. Not infrequently the cost of removal exceeds the amount recoverable. Work in process inventory may also have little resale value in its unfinished state. On the other hand, assets such as land and buildings sometimes have a large opportunity cost value.

4.18 So long as management retains operating assets in use, prices that could have been obtained by disposal on a historical balance sheet data are only costs of rejected opportunities. Presumably, the opportunities were rejected because they were judged less profitable than the opportunities associated with continued retention of the assets.

> For example, the fact that a factory stands on a site which has increased or decreased in value has no significance to recipients of the balance sheet so long as the site remains the most economical location for the plant and the company has no intention of realising the current value by sale.

If the company does not become a party to an actual transaction at current prices, it can experience no

corresponding cash flows and its capital remains unchanged. Under these conditions, which are representative for most operating assets held by going companies, current opportunity costs have no relevance to investment decisions by management or investors.

4.19 In addition to assets held for future use, there are also assets held for future sale in their present form, after conversion operations have been performed, or when further use becomes uneconomical. Among such assets are merchandise inventories, securities and real estate held as investments (as distinguished from items of similar nature held for use or to control assets for use), mineral deposits held for exploitation, and surplus assets held pending disposal. For these, current prices in the market where sales would normally be made are evidence of profit opportunities and hence relevant for forcasting cash flows to be experienced by the company in the future. Of course, market prices may change before sales are made and hence the indicated receipts need to be viewed as uncertain in amount. Since some costs of making disposal will generally be incurred and for unfinished products completion costs will also be incurred, current value usually means net realisable value after deducting estimated costs of completion and disposal.

4.20 Replacement cost is relevant for forcasting future cash outflows which will be required to replace

assets presently owned. In forecasting the impact of replacement costs on future cash flows, the costs needed are those which will be experienced at the time replacements are actually made. Current acquisition costs may be acceptable estimates of costs that will be incurred to replace short-lived assets such as inventory. On the other hand, the costs that will be incurred in the more distant future when replacement of long-lived items such as buildings and equipment take place may be substantially different from present costs. Hence current replacement costs for assets other than inventory often have little usefulness for predicting the amount of funds that will be needed in the future for replacing present assets.

4.21 Moreover, when one attempts to apply the concept of replacement cost to a company's plant and equipment as a whole, it is virtually impossible to define what is to be valued in terms sufficiently specific to guide the measurements. Much industrial equipment is not replaced with identical or even with similar items. What happens is often better described as gradual withdrawal of capital invested in old equipment and continuing reinvestment in new and different equipment, often to produce new and different products. Many of the assets which will succeed these new owned are not even available today.

4.22 Difficult problems are encountered in measuring replacement costs because there is often no real market

for many of the assets held by a business. Consequently, objective evidence to support replacement costs is lacking. The units in which valuations are made may have an important effect on the results. Thus the cost of acquiring an entire plant as a unit may be quite different from the costs of acquiring the separate components in units of varying sizes. Construction cost indexes are often used for determining replacement cost, but cost indexes tend to lose meaning as technological changes take place. Some of the problems which arise may be illustrated with the valuation of a twenty-five year old warehouse.

> When historical material and labour cost content of the building was adjusted to the current level with construction cost index, the resulting replacement cost was approximately three times the original cost. It was recognised that this replacement cost figure was meaningless because a building of the same type would not be built today. New materials, new construction methods, and new designs had replaced these current when the warehouse was built.
>
> As an alternative, the cost of a building of modern design and equivalent capacity was estimated. While this cost was lower than the preceding one, the volume of orders handled was not large enough to provide an acceptable return on the investment in a new building. Moreover, this volume was expected to decline with geographical shifts in the company's market. Since it was evident that replacement was uneconomical, management decided to continue using the old building with the expectation that operations at the location would eventually be discontinued and customers served from another warehouse nearer the center of the market
>
> While replacement cost was useful in deciding what action to take, it did not measure the remaining investment in the present building.

4.23 In any given application, the accountant is faced with multiple alternative versions of replacement cost and the choices among these versions have to be guided largely by arbitrary and expedient considerations. When no actual replacement is intended at the present time, the concept of current replacement cost is so vague that the question of what to value and how to make the measurements cannot be answered with assurance that the results will have significance. Where this occurs, the real source of the difficulty lies in the fact that the concept of replacement cost is simply irrelevant for the purpose. While revaluations were common in the nineteen twenties, appraisal accounting for reporting to investors has practically disappeared in the United States.

4.24 On the other hand, when current costs are genuinely relevant, both conceptual and measurement problems can usually be satisfactorily solved. To illustrate, the opportunity cost of present assets and the acquisition cost of alternative assets are relevant concepts when replacements are actually at issue. Decisions as to when and with what to make replacement are guided by costs assembled in special studies made for the purpose rather than by data reported in the periodic summary balance sheet. In such studies, the items to be costed and the sources of price quotations are specifically identified so there is no difficulty in defining the unit to be valued or in measuring the desired cost.

4.25 The historical cost of an asset is established by a bargained price in a transaction to which the reporting entity is a party and represents current value at the time of acquisition. Acquisition cost measures the amount of liquid capital committed to acquire assets. In these respects, historical cost differs from the various concepts of current cost because measurements of current cost do not originate in actual entity transactions and hence do not have any corresponding flows of funds.

4.26 The duration of the benefits received from some expenditure is brief and the capital committed is either promptly recovered or lost. Such expenditures are accounted for as current expenses. For other outlays, the investment cycle is longer and some or all of the capital remains unrecovered at the end of the current reporting period.

4.27 Determination of profits by periodic matching of costs with revenues leads to use of asset accounts as a temporary repository for cost awaiting matching in future periods. Since assets such as inventory, plant and equipment, and prepaid expenses will be taken into future income statements as expenses, Herman W. Bevis has remarked that these items " ... constitute a kind of gigantic footnote to the income statement." This integration of the balance sheet with the income statement requires use of the same concepts of cost in both sets of accounts. Non-financial assets are stated at historical cost because it is consistent with concepts of cost generally used in measuring periodic profits.

4.28 The rationale underlying the choice of historical cost for measuring profits is explained. For purposes of summary reporting, the accountant assumes that the enterprise will continue in existence indefinitely unless there is reason to assume the contrary. Consequently, the customary annual, quarterly, and monthly financial reporting periods are arbitrarily established interim periods in an indefinitely long series of like periods. For this reason, an individual period does not stand by itself and the results reported for any one period have little meaning unless viewed as a segment in a continuing stream.

4.29 In a project or venture with limited life, the lifetime aggregate profit is uniquely determined as the difference between cash inflows and outflows other than contributions from and distributions to suppliers of capital. Measurement of profit for interim periods should sum to the lifetime aggregate. Where an enterprise has an indefinitely long life, the aggregate lifetime income is indeterminate. Hence the periodic rate of profit together with trends in that rate are the significant figures. The differences may be illustrated by investments in bonds and stocks. To the buyer of a bond, the lifetime cash flows and the timing of these flows determine the investor's rate of return. On the other hand, only the periodic return is considered in ascertaining rate of return from an investment in a stock. In effect, the investor views the annual return as a perpetuity.

4.30 As figures for an interim period in an indefinitely long series, periodic profit figures should articulate with periods which precede and follow. Articulation means that changes from period to period should be explainable as the result of economic events which have affected enterprise assets and equities. In addition, the profit reported for an individual period should be relatable to trends in a series of such figures, and to the cumulative total. Given these characteristics, periodic profit figures for a series of successive prior periods have some usefulness in forcasting future profits to guide investment decisions. Subsequently reported historical figures can also be compared with corresponding forecasts made previously and variances explained. Measurement techniques which introduce erratic fluctuations or bias unrelated to long term rates of change in profit reduce the reliability with which forecasts of future profits can be made for past experience. When there is no material amount of unrecovered investment or uncollected revenue at the end of the accounting period, each period encampasses a completed investment cycle and profit may be determined by matching cash receipts and cash outlays. However, there are comparatively few going businesses where profit can be reliably measured on a cash basis. Usually there are significant loads and lags in the timing of investment outlays and the related receipts. Thus a going business includes numerous individual investment

projects, each with its own cycle period and time pattern of outlays and receipts. The investment cycle for long-lived assets such as buildings and machinery or for expenditures for research and market development usually stretches over a number of years. Measurement of periodic profit has become increasingly difficult as advanced technology and greater mechanisation have increased the proportion of enterprise capital invested in such resources. Even for items such as inventory having a relatively short turnover period, there is often a substantial unliquidated investment at the close of a customary reporting period. Under such conditions, the cash outflows and inflows during an individual period have little relationship to each other and a cash basis profit figure would not meet the criteria for a useful periodic income figure.

4.31 Accrual accounting was developed to associate costs with the related revenues. The ideas underlying this process for determining periodic income are summarised by A.C. Littleten in the following words:

> The central problem of accounting is to bring into association, in the present, the revenues identified with the future and their related costs. In solving this problem these who use accounting are in effect, matching enterprise efforts and accomplishment. Some efforts are effective in the present, they are measured by the costs (effort) currently deductible from revenue (accomplishment); they are the revenue costs of the present. Other costs are expected to be effective in the future; they are measured by the costs that are deferred as being revenue costs of the future (assets). Some

efforts prove ineffective in the present and are judged unlikely to be effective in the future; they are measured by the costs that must be deducted from revenue as recognised losses.

The fundamental problem of accounting is therefore to cut through a continuing stream of costs and correctly assign portions to the present and to the future.

HISTORICAL COSTS RESTATED IN TERMS OF THE CURRENT PURCHASING POWER OF MONEY

4.32 Commenting on an accounting research study by the American Institute of Certified Public Accountants on the subject of "A Tentative Study of Broad Accounting Principles for Business Enterprises" by Robert T.Sprouse, Ph.D and Maurice Moonitz,Ph.D., CPA, Arthur M.Cannon has forecefully brought out the inadequacy of the general price level in the context of restating historical costs in terms of current value in the following terms:

4.33 Like all averages, the changes in general price level conceal at least as much as they reveal. There is a tremendous variety and range of individual changes within that average - some above and some below, some very widely divergent, and some going one direction while the average goes the other, etc. These individual changes probably mean more than the over-all price-level change in evaluating the financial condition of a particular business.

4.34 Let me use an illustration. The other day we made a mortgage loan for the construction of a

new shopping center in San Jose, California, a very fast growing area. The land in question was the sole asset of the owner, and he had purchased it as a farm for $ 8,000 about fifteen years ago. It was currently appraised at $ 300,000, and we made a mortgage loan of $ 330,000 for the new construction, the total value when completed to be $ 650,000. The over-all price level in the period the farmer held the land approximately doubled. If we accountants prepare a statement for this farmer just before the indicated transaction, we would show the asset at $ 8,000 and net worth at $ 8,000 (other items excluded). If we took the price-level change into account, we would show the asset at $ 16,000 and the net worth at the same amount. The change in the price level is trivial in comparison with the over-all change in value. After the construction and the loan are completed, a traditional accountant's statement would show the land and buildings at $ 358,000, the loan at $ 350,000 and the net worth at $ 8,000, and, if the price-level change were recognised, then the asset would be $ 366,000, the loan $ 350,000 and the net worth $ 16,000. This statement of financial condition is a long way from financial condition, whether based on cost or whether based on cost adjusted for the price-level change. What is needed, of course, is to show the land at its current value, $ 300,000 - in which case the total asset will be $ 650,000, the loan $ 350,000

and the net worth $ 300,000. In that net worth should be reflected cost $ 8,000, adjustment by reason of price-level change, another $ 8,000 and appreciation by reason of holding in a rising market, $ 284,000.

A BASIC ACCOUNTING PHILOSOPHY

4.35 Dr. Raymond P. Marple, Ph.D., CPA, in his article 'Toward A Basic Accounting Philosophy' also published by N.A.A. explains the rationale of historical accounting in the following terms.

4.36 The concept of capital should not be confused with wealth in the way some of our current value theorists have confused the two terms. Wealth and value are the concern of the economists; capital and exchange prices are the concern of the accountant. The distinction between wealth and capital is clear if we recognise that man's economic activities are carried on for the purpose of producing wealth - goods and services which satisfy human wants - and that capital is that part of the production - consumption stream diverted from consumption for use in producing added wealth. Capital is wealth committed to productive use.

4.37 There is a duality in accounting w hich arises out of the recognition w hich accounting affords of the two aspects of capital - its form and the rights

to it. If accountants were concerned only with the forms of capital (assets) in a business enterprise, income measurement would be impossible, because of inability to determine whether the change in total capital (assets) during a period resulted from capital use or from capital contributions and/or withdrawals. If, on the other hand, accountants were concerned only with rights to capital, measurement of income would require physical inventories, and valuation of assets at the beginning and end of each period. But double-entry accounting, by recognising both the forms of and rights to capital, enables the accountant to measure the increase or decrease of a total capital by time periods while preserving a running record of capital forms and capital rights.

4.38 The above reference to time and time periods is important. Income is capital growth and growth takes place through time. Capital is wealth used productively. The measure of its productivity is its increase or growth per unit of time. Income as an account lacks significance unless related to the capital used in its generation and the time necessary for its generation.

4.39 Just as economics (being concerned with wealth) uses value as its common denominator, so accounting (being concerned with capital) uses exchange prices as its common denominator. The measuring stick in each case is the same - monetary unit - which perhaps explains why the two concepts, price and value are so often confused.

4.40 Historical accounting uses exchange prices rather than values as its common denominator because accounting is factual rather than assumptive. Acc ounting is concerned with what was done rather than what might have been done or what may be done in the future. Accounting is transaction based because it is concerned only with these actions which were taken, not the opportunities foregone or anticipated for the future. Thus the "values" of concern to accounting are those established by exchange - the prices agreed to by the two parties to the transaction.

4.41 To understand the importance of exchange prices in accounting it is necessary to recognise the way in which capital is used in the operation of a business. Each business is organised for a specific economic purpose. To achieve this purpose the capital funds of the business are used to acquire buildings, equipment, tools and inventories and to pay operating costs. These commitments are made in the expectation that they will result in products or services which can be exchanged for liquid capital. If the liquid capital inflow from such exchange exceeds the committed capital outflow, an income (increase in capital) results. The committed capital outflow is measured by the exchange prices which applied to the transactions incurred at the time the capital was committed.

4.42 Committed capital differs from liquid capital because it has been committed to income production. Liquid capital can be used for many purposes; for paying debts, for distribution to stockholders, for paying taxes, and for making additional commitments. But committed capital has only one use; providing the goods and services which can be converted into liquid capital by future exchange. Accordingly, a change in the "value" of an asset at any time after capital has been committed in it and before the capital so committed has been recovered, in whole or part, through exchange, has no effect on the capital committed. Because accounting is concerned with capital used for production rather than wealth used for consumption, the amounts of capital employed in production do not change until the purpose of the commitment has been realised.

4.43 If capital increase or decrease (income or loss) is to be measured by time periods, capital commitments must be assigned to time periods. For a single time period this requires a measurement of the previously committed capital which has expired during the time period. It does not require a "valuation" or re-statement of the committed capital which remains for application against future time periods. If the income to be reported in future time periods is to be a proper measure of the increase in capital resulting from actions taken, the capital committed for future time periods must be carried at the amounts committed until the purpose of the commitment has been realised.

FIXED ASSETS AND DEPRECIATION

4.44 The recommendations on accounting principles of the Institute of Chartered Accountants, England Wales concerning the nature of fixed assets, depreciation, balance sheet and profit & loss account, as are relevant to the subject of our study are reproduced below.

4.45 Fixed assets, whatever be their nature or the type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purpose of sale in the ordinary course of business. The amount at which they are shown in the balance sheet does not purport to be their realisable value or their replacement value, but is normally an historical record of their cost less amounts provided in respect of depreciation, amortisation or depletion.

4.46 Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned.

4.47 The assessment of depreciation involves the consideration of three factors: the cost of the asset, which is known, the probable value realisable on ultimate

disposal, which can generally be estimated only within fairly wide limits, and the length of time during which the asset will be commercially useful to the undertaking. In most cases, this last factor is not susceptible of precise calculation. Provisions for depreciation are therefore in most cases matters of estimation, based upon the available experience and knowledge, rather than of accurate determination. They require adjustment from time to time in the light of changes in experience and knowledge, including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset.

4.48 Provisions for depreciation, amortisation and depletion of fixed assets should be applied on consistent bases from one period to another. If additional provisions prove to be necessary, they should be stated separately in the profit and loss account. Where practicable, fixed assets in existence at the balance sheet date should normally be shown in the balance sheet at the cost and the aggregate of the provisions for depreciation, amortisation and depletion should appear as deductions therefrom. The extent to which these provisions are being kept liquid will then be ascertainable from the balance sheet as a whole.

4.49 The function of a balance sheet is to give a true and fair view of the state of affairs of the company as on a particular date. A true and fair view implies

appropriate classification and grouping of the items and therefore the balance sheet needs to show in summary form the amounts of the share capital, reserves and liabilities as on the balance sheet date and the amounts of the assets representing them, together with sufficient information to indicate the general nature of the items.

4.50 A true and fair view also implies the consistent application of generally-accepted principles. Assets are normally shown at cost less amounts charged against revenue to amortise expenditure over the effective lives of the assets or to provide for diminution in their value. A balance sheet is therefore mainly an historical document which does not purport to show the realisable value of assets such as goodwill, land, buildings, plant and machinery; nor does it normally purport to show the realisable value of assets such as stock-in-trade. Thus a balance sheet is not a statement of the net worth of the undertaking and this is normally so even where there has been a revaluation of assets and the balance sheet amounts are based on the revaluation instead of on cost.

4.51 The general aim of a profit and loss account should be to show a true and fair view of the profit or loss of the year, before and after taxation, based on the consistent application of recognised accounting principles. The account should be presented in a form which affords as clearly and readily as circumstances permit a comparison with the results of previous years.

CHAPTER 5

THE NATURE OF FUNDAMENTAL ASSUMPTIONS ON WHICH PART I OF THE REPORT IS BASED

FUNDAMENTAL ASSUMPTIONS

5.1 Many statements and / or assumptions have been made in Part I of the Report. For the present, I propose to deal with only two fundamental assumptions on which the entire theme has been presented. These are:

1. Provision for depreciation based on historical cost leads to capital erosion by its failure to provide adequate funds needed for replacement of assets at increased prices as a consequence of inflation.

2. Capital in business enterprises needs to be protected against fall in values as a consequence of inflation.

THE FUNCTION OF DEPRECIATION IN ACCOUNTING

5.2 Historical cost of depreciable assets is a deferred charge to be deducted from revenues during the useful life of the asset. Depreciable assets eventually wear out or become obsolete. In order to avoid less of capital invested in these assets, the capital must be recovered during the period of its economic usefulness in the business. The process of accounting for depreciation is designed to facilitate this recovery of capital through sales revenue. The emphasis in accounting is that the true function of depreciation charges is that they are costs to be recognised in determining net income.

5.3 The International Accounting Standard IAS 4 on Depreciation Accounting approved in July 1976 states:

> 'Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly.'

The assumption that the basic function of depreciation is to provide funds for replacement of the depreciable assets has no foundation in accounting. If it were so, recovery of capital through depreciation charges recovered from sales revenue, would not be available for other purposes such as for redemption of loans. Acquisition of business assets either for the first time or subsequently as replacements are normally to be financed by a combination of equity and debt in reasonable proportions. Recoveries of such capital through depreciation charges on assets earned through revenue are, however, legitimate sources for redemption of debts in general and in particular those raised for their acquisition. The assumed function of depreciation to provide funds for replacement naturally has no place in the International Accounting Standard on Depreciation Accounting.

5.4 The point of view that depreciation charges should provide funds for replacement of assets reflects the management's conception of what should be accomplished by depreciation charges in furtherence of business interests. Accounting, however, needs to be impartial as between different interest groups and concepts such as justice, truth and fairness in financial statements are fundamental to accounting principles.

5.5 Even so, it would be worthwhile to examine the validity of the assertion of the current value theorists that provision for depreciation based on historical costs leads to capital erosion by its failure to provide adequate funds in the context of inflation.

THE ADEQUACY OF DEPRECIATION BASED ON HISTORICAL COSTS

5.6 The concept of the time value of money is too well known to need any explanation here. Recovery of capital invested in depreciable assets is recovered through sales over the economic life of the assets. Funds made available through these recoveries may be used for investment in business assets which earn the going-rate of return. Alternatively they may be used for the retirement of debt, which results in the saving of interest charges which would otherwise be incurred. A third alternative may be the profitable employment of these funds outside the business. Whatever be the alternative uses to which these funds may be put to, it is evident that they earn a rate of return which compounds with time.

5.7 Depreciation methods followed in India are principally of two types. The written-down-value method is the one relevant for tax purposes in our country. In addition to this, the straight-line method is also permissible for determining the surplus available for dividends in the case of limited companies, to be calculated in the manner prescribed under the Indian Companies Act. For the purpose of illustration that follows, a rate of 10% for depreciation under the written down value method is assumed as an example. This would correspond to a 22-year life period leaving 10% of the original historical cost as the assumed salvage value at the end of the asset life. The equivalent straight-line depreciation rate is 100/22% or approximately 4.5% per annum. Current rates of return net of tax

are assumed at four different levels, namely, 6,8,10 and 12% per annum at which rates the annual cash inflows on account of depreciation funds are compounded. The accumulated amounts thus computed, expressed in terms of number of times of the original historical cost of the asset, are tabulated below:

Post-tax Rates of Return %	Cumulative Funds at the end of life of the assets - Number of times the original historical cost	
	Written Down Value Basis	Straight Line Basis
6	2.29	1.77
8	3.06	2.18
10	4.12	2.70
12	5.55	3.28

The guidelines on price-fixation issued by the Ministry of Economic Affairs stipulates a minimum post-tax rate of return of 10%. Actual rates allowed are in the region of 12 to 15%. In comparison with the general price level indices over any span of 22 years in India, the generation of funds, out of depreciation based on the so-called 'out-of-date historical costs' is very nearly equal to if not more than that required to effect the effect of inflation.

5.8 In further proof of the above fact, the experience of Tata Iron and Steel Company Ltd. over a period of 52 years, compiled with reference to the company's published annual accounts are indicated below:

(Rs. crores)

As on 31st March....	Gross Block	Depre-ciation	Borro-wings	Paid-up Preference Shares	Capital Equity Shares
1926	20.8	4.9	6.7	7.7	2.8
1960	177.9	55.0	77.1	11.4	20.7
1978	438.5	282.5	87.7	11.4	20.7

Bonus shares forming part of the paid-up capital are excluded, since they represented capitalisation of retained profits and did not involve fresh capital brought in by the share-holders. Share premiums, being equity contributions in cash,

have been included as part of paid-up capital. The company has paid all preference dividends uptodate. Except for a brief spell of 5 years during the later half of 1920s, handsome dividends had been paid right through all the years. Dividends paid on deferred shares when they existed were at fantastically high rates. Dividends paid during the 1940s were in the region of 30 to 40% on ordinary shares. During the recent years when some dividend restrictions were imposed, they lamented that they could not declare more. For the 3 years ending upto 1981, the company has undertaken not to declare more than 12% on ordinary shares, as a condition when new prices were sanctioned by the Government. For nearly three decades if not more, immediately preceding the latest financial year upto which accounts have been closed, the products of the company were subject to price controls. Depreciation was provided on historical costs.

5.9 From the figures quoted in para 2.7, the following conclusions are evident:

1. During the 34 years from Ist April 1926 to 31st March 1960, the company financed additions to fixed assets out of:

	(Rs. crores)
(a) Shareholders' funds	21.6
(b) Borrowings	70.4
(c) Internal generation of funds	65.1

aggregating to Rs.157.1 crores.

2. During the 18 years, from Ist April 1960 to 31st March 1978, when the company's products were subject to price discipline and depreciation provisions were made on historical costs, the company added Rs.260.6 crores to their gross block of fixed assets. Shareholders brought in no money during this period. Net additional borrowings during the same period amounted to Rs.10 crores. Internal generation of funds made available for financing fixed assets aggregated to more

than Rs.250 crores, mostly representing depreciation recoveries earning compounding rates of return. The Company describes most of the additions to gross block as replacements and / or modernisation.

5.10) On the top of this, the Directors' Report to shareholders for the year ended on 31st March 1978 contained the following observations:

"Our excellent present Term Debt/Equity ratio of 0.20:1. provide some indication of the company's substantial capacity for additional term borrowings."

5.11 . . The same Directors' Report laments the price increase sanctioned by the Government as a disappointment.

5.12 Innumerable examples of actual business conditions of similar kind can be quoted, which are within my knowledge and experience.

PROTECTION AGAINST INFLATION

5.13 The second assumption that capital and business enterprises needs to be protected against fall in values as a consequence of inflation is an unjustifiable proposition. Shorn of all paraphernalia, what is implied, in effect, is that the investments by equity shareholders in companies should be protected against fall in values as a consequence of inflation to the exclusion and at the cost of other segments of society. Business is financed out of equity and debt in reasonable proportions, as already pointed out. It is not the case of the current value theorists that lenders of capital who contribute almost twice, if not more, the contributions made by shareholders towards acquisition of business assets, need to be protected against such fall in values. What is advocated is that such protection is only for the benefit of equity shareholders' investments in business concerns. This will be evident from the fact that the debt equity ratio of most companies in the private sector are 2:1 or even more in favour of equity and borrowings are to be repaid only in specified amounts of money, not subject to any adjustments for variations in the purchasing power of money.

5.14 When the purchasing power of money has fallen in a country, there is nothing which can really be protected against erosion of capital. Even the money invested in bank deposits is subject to this fall in terms of real value. A major source of loanable funds made available to business concerns is the savings of the community in general channelised through the country's banking system. Even the life-time savings of the employees in the form of provident fund and other superannuation funds are subject to fall in values as a consequence of inflation. It is not the case of current value theorists that all these sections of the community should be protected against the consequences of inflation, even though it is precisely the savings of these sections with which business assets are in most part financed. Since the falling purchasing power of money erodes capital saved of all sections of the community, expressed in money terms, if one section of the community viz. equity shareholders of companies are to be protected against inflation, it would only mean that it has to be at the cost of the other segments of the society. This is so because such protection is feasible only through increased prices to consumers and/or reductions in the remuneration payable to employees and other factors of production. By what right this particular section of the community is to be entitled to this kind of privilege at the expense of the other sections of the community has to be established. We cannot legitimately proceed on the premise that accounting principles, rules or procedures should serve only a special interest.

CHAPTER 6

JUSTICE, TRUTH AND FAIRNESS IN FINANCIAL STATEMENTS

FINANCIAL STATEMENTS ARE INTENDED TO SERVE DIFFERENT INTEREST GROUPS

6.1 The accounting research study by the American Institute of Certified Public Accountants (AICPA) on "A Tentative Study of Broad Accounting Principles for Business Enterprises" referred to in Chapter 1 of Part II of this Report makes the following observations in its introductory chapter:

> Accounting supplies much of the comprehensive and dependable information that the management needs to control and administer the resources in its charge efficiently and productively. It also supplies the data that management needs to fulfil its responsibility to report to owners, creditors, government and others with bona fide interests. In turn, these owners, creditors, government and others rely on accounting reports to assist them in determining and evaluating the performance of management and the business system.

The accounting principles have, therefore, to be designed to meet the needs of all interested groups.

6.2 Mr. Paul Gredy in his comments on this treatise pointed out:

> Accounting serves many purposes in the broad fabric of incorporated business enterprises. The most important is to supply a comprehensive and dependable information required in order that management may fulfil its fiduciary accountability to stock-holders, creditors, governments and others having bona fide interests. The principles of financial accounting in corporate business enterprises logically and usefully may be classified in relation to these fiduciary accountabilities.

6.3 The preparation and presentation of periodical financial statements of corporate enterprises are the primary responsibilities of those in management in their fiduciary relationships with the various interest groups indicated earlier. By subjecting these financial statements to scrutiny

and certification by professional accountants, credibility is sought to be established to the effect that the financial statements presented by those in charge of the affairs of corporate enterprises do represent a true and fair picture of their financial condition and performance, in the context of such fiduciary relationship.

CRITERION OF USEFUL PURPOSE

6.4 Many forces have been at work in trying to shape the specific content of accounting and of published financial statements in recent times. The 'usefulness' as a criterion is usually stressed in all these endeavours.

6.5 Dr. Maurice Moonitz, Ph.D., CPA, points out:

> Anyone who stresses 'usefulness' as a criterion, in accounting or elsewhere, must answer two pointed questions - useful to whom? and for what purpose? And herein lies the danger. We could easily be trapped into defining accounting and formulating its postulates, principles and rules in terms of some special interest, such as the business community, or the regulatory agencies, or investors, or tax collectors. But accounting has been used in the affairs of private business, regulated and unregulated of profit-motivated enterprises as well as non-profit ones, of illegal as well as legal enterprises of socially undesirable as well as desirable entities, of organisations in socialist, fascist, or communist states as well as those in free enterprise societies. We cannot proceed on the premise that accounting is the monopoly of one group, whether that group is concerned mainly with the development of the accounting process or with its end-product in the financial statements and reports.

6.6 An eminently satisfactory application of the criterion of useful purpose is set forth in the following passage on page 7 of Accounting Research Bulletin No.43 of the American Institute of Certified Public Accountants:

Accounting is essential to the effective functioning of any business organisation, particularly to the corporate form. The test of the corporate system and of the special base of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole - not merely from that of any group of interested persons.

JUSTICE, TRUTH AND FAIRNESS

6.7 In the accounting research study published by AICPA on 'The Basic Postulates of Accounting' by Maurice Moonitz, Ph.D. CPA, the following observations are found:

> "Ultimately, the results of any purposive human activity must be judged in the light of the value judgements inherent in ethical concepts.

6.8 Mr. Leonard Spacek commented:

> This would involve such matters as 'justice, truth and fairness'. The one basic accounting postulate underlying accounting principles may be stated as that of fairness - fairness to all segments of the business community (management, labour, shareholders, creditors, customers and the public) determined and measured in the light of the economic and political environment and the modes of thought and customs of all segments - to the end that the accounting principles based upon this postulate shall produce financial accounting for the lawfully established economic rights and interests that is fair to all segments.

6.9 Mr. D.R. Scott, in his article on 'The Basis for Accounting Principles' gives the following 'general statements' in which he relates 'accounting rules and procedures to underlying principles':

1. Justice - equitable treatment should be accorded to all interests involved in the financial situation covered by the accounts.

2. Truth - accounts must not be made a means of misrepresentation.

3. Fairness - accounting rules, procedures, etc. should not serve a special interest.

He adds two other items which he states are subordinate to the three listed above:

4. Adaptability - accounting rules, etc. must allow for changing economic relations.

5. Consistancy - rules, etc., should never be changed arbitrarily or to serve temporary purposes.

In a field such as accounting these concepts and their implications cannot and should not be ignored.

ARBITRARY CONDITIONS

6.10 The discussions in preceding two chapters would make it abundantly clear that the 'accounting principles' propagated by current value theorists lead to arbitrary conditions relating to valuation. As to valuations of fixed assets, we need only consider the variety of appraisals that can be obtained on request. The observed stress in present day accounting on 'objectivity' and on 'historical Cost' and the wide-spread antipathy to 'appraisal' and to value not based on an exchange are not merely the problem of evidence for the accountants but more the problem of arbitrariness involved in such valuations.

6.11 Subjective judgements became necessary under conditions of the kind referred to in paras 4.20 to 4.22 of Part II of this Report if a valuation has to be made. The Accountants' reaction under these circumstances is naturally one of 'conservation' which represents in essence merely a counsel of caution.

6.12 Accountants generally hesitate to recognise a favourable change indicated under arbitrary conditions 'too early' because it may never be 'realised' and the party to whom the benefit flows may prematurely demand his share or act on the presumption that it is his.

REACTIONS OF THE ACCOUNTING PROFESSION AND THE WORLDWIDE POSITION

6.13 Accounting for the effect of inflation is a subject that has been considered, written about and discussed for many years by the Accountants throughout the world. These will undoubtedly reveal the widespread reluctance to adopt a formalised system of reporting other than 'historical cost' accounting and the reasons therefor.

6.14 The accounting profession is in the inequitable situation of being responsible for financial statements of truth and fairness without the commensurable authority to base these statements upon principles in which it believes.

6.15 The discussions paper on "The Statement of Changing Prices in Financial Statements - A Summary of Proposals", published by the Inter-national Accounting Standards Committee in March 1977 reflects to position upto November 1976 in various countries. This may not need a reproduction here. However, it may be relevant to indicate the position as obtaining in the most industrially advanced countries of the world amongst the member countries of the above International Body.

6.16 U.S.A. - In August, 1975, the Security Exchange Commission (SEC) notified that it proposed to amend its regulations so as to require certain replacement cost data in notes to corporate financial statements. The SEC received some 350 letters of comment, most of which urged delay. About 90 per cent were reported to be negative (Refer 'Replacement Cost Accounting; ACPA's View' by Robert W. Barliner R. Management Accounting December 1977; and 'Replacement Cost Accounting Plan adopted by SEC', Article in the Wall Street Jaurnal 25 March, 1976 However, SEC judged that the information was presently needed by investors and should not await the development of detailed procedure. It encouraged a degree of experimentation and expected some improvisation and subjectivity. The SEC in March 1976 amended its regulations to require any company with inventories and gross fixed assets which together aggregate more than United States $ 100 million, and comprise more than 10 per centof total assets to disclose replacement cost data. However, a description of the methods employed and the presentation of other information of which management is aware and which it believes is necessary to prevent replacement cost data from being misleading, are required to be disclosed.

6.17 Germany

The Accounting Standard issued in October 1975 by Institute der Wirtescherftsprufur in Deutischland o.B recommends that supplementary information be presented in the financial statements of public companies and other enterprises that prepare an annual report to Stockholders. The information is referred to as the 'Fictitious Profit' and is comprised of the additional depreciation of cost of goods sold that could be determined if a replacement cost value had been used reduced by .the proportion of the inventories of fixed assets that are financed by other than equity capital

6.18 U.K. -

In July, 1977 a referendum held by the Institute of Chartered Accountants, England and Wales resulted in a majority voting against any compulsory reporting of current cost accounting data in financial statements.

6.19 Canada -

The guideline approved in November 1976 by the Canadian Institute of Chartered Accountants does not require the presentation of general price level information. However, it suggests that, if such information is presented, it be presented as information supplementary to historical cost financial statements and include certain balance sheet and income statement items.

6.20 France -

The report of the National Planning Commission issued in November 1976 recommends that, in a preliminary experimental period, listed companies be required to produce a supplementary statement in which their results and financial position are determined on a basis which reflects changes in the general level of prices.

6.21 Belgium -

The October 1976 Royal Decree on Financial Statements of Enterprises indicates that historical cost is the basic principle of valuation.

6.22 CONFLICT

The concept in which accountants generally believe do not restrain or restrict the compilation and presentation of other

kinds of accounting or statistical data for international purposes or as supplementary information included in a published report as part of the disclosure of significant information and as an aid to interpretation of the financial data. In administering the enterprise, business managements always have needed and always will need data outside the formal financial statements. Accountants see no conflict in this.

6.23 Principles of Accounting, however, should not be formulated mainly for the purpose of making good or validating, so to speak, the principles of sound divided, pricing or tax policy. We cannot slip into acceptance ofaccounting principles which are not independent expressions of the results of accounting consideration but instead simply validate the policies established by one or more of the dominant groups of vested interest.

NATIONAL INTEREST

6.24 It would appear that subtle but powerful influences are exerting their pressure on developing nations, directly or indirectly, for introducing 'accounting reforms' leading to current value statements and to abandonmentof 'historical cost' concepts. National interest, however, would demand that a careful examination of the problems such as these need special attention before we embark upon a course which even the advanced countries fear to tread:

(i) Will the current value concepts as propagated lead to financial statements that would reflect justice, truth and fairness to all the segments of society?

(ii) Will they lead to financial statements that are intended to support increased claims for repatriation of capital and/or

returns on foreign investments in the country?

(iii) In a free market, will the application of these concepts lead to artificially inflated costs and returns that may be used to justify reduced remuneration for other factors of production?

(iv) Under conditions where prices are subject to control, will the application of current values result in claims for increased prices setting off in their turn another spiralling inflation which we strive to contain?