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COMPREHENSIVE OF PRICE LEVEL CHANGES IN EVALUATION & ACCOUNTING PURPOSE

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Comprehensive of Price Level Changes in Evaluation & Accounting Purpose

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Abstract – A business comes into existence primarily to make profit. In this attempt it provides goods and services to the community. It also provides means of livelihood to some members of the community by creating employment opportunities. These are sound subsidiary or secondary motives. The all-important motives of a running business however is to make profit."PROFIT TO A BUSINESS IS LIKE FOOD TO A HUMAN BODY : THE BODY MUST GROW AND DEVELOP – WITH THE ASSISTANCE OF FOOD. TAKE AWAY THE SUPPLY OF FOOD AND THE BODY WASTES AWAY AND DIES." Every type of businessman to find out the amount of profit earned during a certain period (called Accounting Period) usually an year. In order to find out the amount of profit or loss, he must have a complete and systematic record of the business transactions i.e. dealings in money or monetary terms, entered into during the fiscal year.

Keywords : Business, Systematic, Opportunities

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EVALUATION

An evaluation policy is a systematic statement of the rules or principles which underline or govern of set of phenomena. An evaluation policy may be viewed as a framework permitting the organization of ideas, the explanation of phenomena and prediction of future behaviour.

A policy of evaluation is above all an explanation. There is a wide spread misconception that a evaluation policy must aid prediction, but not all policies do. The policy of evalution e.g. has no predictive ability whatsoever. It is impossible to use it to forecast changes which will take place in living things.

An evaluation policy is an explanation, but not every explanation is an evaluation policy. In science, a policy is an explanation of phenomena which accounts for them to the satisfaction of knowledgeable persons and this presupposes that the policy consists of predictions, each of which can be established by empirical research or is necessary for the explanation in question and has not been demonstrated to be false.

EVALUATION AND INTERPRETATION OF ACCOUNTING

Evaluation is the process of critically examining in detail the accounting data contained in the financial position statement. Individual items are studies, their relationship with other relevant figures established, the data is sometimes re-arranged to have better understanding of the information and use made of different techniques for the purpose. According to R.W. Metcalf and P.L. Titard, Analysis of financial statement is a process of evaluating relationship between component parts of financial statements to obtain a better understanding of firm's position and performance. Analysis is thus a process an activity of segregating the important elements of the financial statements and putting them in comparison to the other related elements it is, thus a technique of X-raying the financial position and the performance of the enterprise.

Evaluation by itself would be a fruitless exercise, if it is not followed by Interpretation i.e. drawing conclusions to serve as a basis for decision and action. Interpretation development on evaluation analysis just as dignosis of disease depends upon clinical examination, in the same way interpretation is based on evaluation analysis. The effectiveness and reliability of evaluation analysis rarely determins the correctness of interpretation. But one additional factor is the 'interpreter himself, it is his skill experience, understanding and intelligence that in fact, draw the conclusion from the evaluated analytical tests.

Right choice of the technique of 'EVALUATION' right use of tools and the right 'INTERPRETER' i.e. the person having professional training and endowed with the requisites, sharpness and intelligence all these three factors rerequired to draw : Proper conclusions, influences and opinion. 'INTERPRETATION' is thus the drawing of inferences what the figures in the financial statements really mean. To quote F. Wood, to interpret means to put the meaning of a statement into simple terms for the benefit of a person

PRICE LEVEL CHARGES & INFLATION ACCOUNTING

Information concerning the financing and investing activities of a business enterprise and the changes in its financial position for a period is essential for financial statement users, particularly owners and creditors, in making economics decisions. When financial statements purporting to present both financial position (balance sheet) and results of operations (Statement of income and retained earnings) are issued, a statement summarizing changes in financial position should also be presented as basic financial statement for which an income statement is presented."

The Balance sheet gives a static view of the sources of finances (liabilities and owners' equity) and the uses (assets) to which these finances have been put at a point of time. But it does not indicate the causes of changes or the movement of finances between sources and uses from the end of one period to the end of the next period. Therefore, an additional statement should be prepared to slow the changes in ASSETS, LIABILITIES & owner's equity between dates of two balance sheets. This statement is referred to as THE STATEMENT OF CHANGES IN FINANCIAL POSITION. Such a statement summaries as : Changes in assets and liabilities resulting from financing and investment transactions during the period, as well as those changes which resulted due to changes in owners' equity.

The way in which the firm used its financial resources during the period of e.g. to acquire fixed assets, to pay debts, to pay dividends to shareholders, and so on.

PRICE LEVELS IN INDIA

We have in consequence a state of continuously rising prices in the country for the last so many years, in other words the value of rupee is continuously falling. The real root cause of a fun demental nature of rising prices in the country in recent years are :

❖ Plan expenditure with a long gestation period.

❖ Increasing deficit financing.

❖ Wasteful officially known as outfitted Public expenditure.

❖ Government policy of import and export etc.

❖ Foreign exchange planning.

In 1956-57, Indian Govt. very heavily depended upon the deficit financing which help in creating inflationary tendencies. The 'price level' was naturally to be raise. The period after 1962-63 is particularly marketed with past aggression hectic funds and thereby creating more inflationary tendencies.

As is very much natural, the price level of the country will continue rising may be at a faster rate. The increasing price level retard and the growth in standard of living particularly, when the prices of consumer goods rise.

The rising price level of our country is a challenge to the economists, planner, Govt., and the public. It is not met with full vigor's and vitality our entire dream of democratic socialism and democratic planning shall doom down to dust. The stability of the price level is one of the most ungently required things.

OBJECTS & TERMINOLOGY OF INFLATION ACCOUNTING

- Inflation accounting indicates real financial statements position.
- Profit and loss account indicates real profit or loss.
- To show reasonable provision for replacement of capital assets taking into consideration the trend price in rise.
- Inflation accounting ascertains real income of capital can be easily ascertained.
- On the basis of inflation accounting effective and workable plans and policies can be framed easily.
- The effect of inflation on business can be found out easily.

The basic objective of inflation accounting is to provide more and useful information than historical cost accounts alone, for the use of management, shareholders, financial institution's researches and other; the statement specifically mentions matters such as the financial is ability of the business, return on investment, pricing policy and gearing. Price level change/ inflation is based on a concept of capital represented by net operating assets (defined below) expressed a current cost, historic cost profit is determined after making certain charges against revenue to maintain history cost capital, while inflation accounting profit is determined by making charge against revenue to maintain current cost accounting capital.

Terminology : Net Operating Assets :

Comprise the capital expenditure including trade investments, stoke and monetary working capital dealt within an historical cost balance sheet.

Operating Capability : Of the business is the amount of goods and services which the business is able to supply with its existing resources in the relevant period. These resources are represented in accounting terms by the net operation assets at current cost.

Current Cost Operating Profit : The surplus arising from the ordinary activities of the business in the period after following for the impact of price level changes on the funds needed to continue the existing business and maintain its operating capability. Whether financed by share capital or borrowing. It is capsulated before interest on net borrowing and taxation.

Current Cost Profit Attributable : To Shareholders : Is the surplas for the period after allowing for the impact of price level changes on the funds needed to maintain their proportion of the operating capability. It is calculated offer interest taxation and extra ordinary items.

Value of the Business :

- Net current replacement cost or if a permanent diminution to below net current replacement cost has been recognized.
- Recoverable amount is the greater of the net realizable value of an asset and, where applicable, the amount recoverable from its future use.

MONETARY WORKING CAPITAL

- Trade debtors, payments and trade bills receivables plus
- Stocks not subject to a cost of sales adjustment, less.
- Trade creditors, accruals and trade bills payable, in so far as they arise from the day-to-day operating activities of the business as district from transactions of capital nature. Bank balance or over draft may fluctuate with the volume of stock. The part of bank balance or overdraft should be included in the monetary working capital, together with any cash floats required to support day-to-day operations of the business, if to do so has as material effect on current lost operating profit, Net borrowing is the excess of :
- The aggregate of all liabilities and provisions fixed in monetary terms (including convertible debentures and deferred tax but excluding proposed dividends) other than those included within monetary working capital and other than those which are, in substance, equity capital over.
- The aggregate of all current assets other than those subject to a last of sales adjustment and those included within monetary working capital.

ADVANTAGES OF PRICE LEVEL CHANGES

As rightly observed by the 'LITTLETION' “Net income determination is an accounting aim and an enterprise. Objective of central importance” 'Inflation accounting' provides tools for a realistic appreciation of net income in a growing or slowing economy where the purchasing power of the basic unit of accounting shows significant fluctuations. Its main advantage are :

- Capital / capital expenditure is maintaned intact.
- The computation / determination of net income is more realistic.
- Financial statement indicates a more realistic picture of the economic and financial health of the enterprises.
- It provides a method of isolation and identification of benefits accring to the enterprise as a consequence of managerial efforts as distinet from those of non-controllable external economic factors.
- The cost of sales which provides guidelines for fixation of price and profit ability of product mix for managerial decisions is far more realistic as compared to historical cost system during periods of hyperinflation or deflation.
- Depreciation on fixed assets at current costs is provided for in the accounts. Amount available for investment when replacement is needed is much nearer the current acquisition cost of the replaced asset.
- Under hyper inflationary conditions, it provides a check against the sense of under feeling of wellbeing in its physical absence.
- It reflects in more concrete physical terms, the dynamic nature of business operations.

LIMITATIONS & DISADVANTAGES OF INFLATION ACCOUNTING

Inflation accounting is a sophisticated tool of management unless managers are tuned to highly refined techniques of modern scientific management and implement them in letter and spirit, refined inflation accounting data will not produce the desired benefits.

- ❖ It violates established and currently well understood meaning of terms like depreciation, cost and profit. It requires development of a new common language of the enterprise for its effective utilization.
- ❖ Even though higher rate of depreciation can be provided the speed in improvement of technology, by the time of replacement of some of fixed assets falls due, may be so fast that the original assets may have become obsolescent. Inflation accounting provides for change in economic value of money but falls to provide for changes in the technological environment of the economy.
- ❖ Determination of appropriate index number for valuation of assets and liabilities will continue to present ticklish problems till the economic and statistical tools of analysis improved further.
- ❖ Inland Revenue authorities of most countries have not so far accepted the basic principles of inflation/ revaluation accounting for determination of taxable income.
- ❖ Its implementation and utilization involves development of higher types of conceptual techniques by managers and accountants leading to higher cost of their training and reorientation.

METHODS OF INFLATION ACCOUNTING

For valuation and accounting purposes

- ❖ Current Purchasing Power Accounting
- ❖ Current Cost Accounting

<u>Current Purchasing Power Accounting (CPPA)</u>

In this method General Price Index Number (GPIN) is used. e.g. a machine was purchased in 1980 for Rs. 80,000, at that time GPIN was 400. In 1990 this index number became 500, than value of machine in 1990 will be found out on the basis of the following formula:

$$= \frac{\text{GPIN of Current year}}{\text{GPIN of Base Year}} \times \text{Histrocial Cost of Calculated Asset}$$

$$= \frac{500}{400} \times \text{Rs. } 40{,}000 = \text{Rs. } 50{,}000.00$$

For the purpose following consideration are made in using CPPA Method :

- ❖ Above given formula is used for conversion of Historical amounts.
- ❖ Conversion of items which occur throughout the year, purchase, sales, wages and advertisement expenses etc. They should be converted on the basis of average Index No. as:

$$\text{Concerned item} = \frac{\text{Index at the close year}}{\text{Average Index No.}}$$

$$\text{Where average Index} = \frac{\text{Index at Beginning} + \text{Index at close}}{2}$$

Note : Opening stock, closing stock and depreciation are not converted according to this Index No.

If opening and closing Index No. as stated above are not given, but Index No. of the middle of the year concerned is given, then this Index No may be used.

- ❖ Calculation of P & L on monetary items, under it adjusted amounts of payments made during the year is found out on the basis of Index Nos (I Ns). Adjusted amount of receipts acquired during the year is found out on the basis of 9 No. Adjusted amount of the working capital of the beginning of the year is found out on the basis of 9 Nos. After various adjust monetary capital of the end of the year is calculated. It this capital is more than the real monetary working capital, then this excess is treated as profit and if it is less, then this deficiency is treated as losses.
- ❖ In 1974 English School of C.A. made the recommendation that after 1962 General Index Number of retail prices should be used.

Problem of Index Numbers : Ascertainment of appropriate index numbers for conversion of historical values of assets and liabilities to replacement valued is of vital significance. Two index number generally published by appropriate government departments are the following :

- ❖ Index of wholesale price and
- ❖ Index of cost of living, also designated as consumer's Price Index.

These are worked out on the basis of appropriate weights to large number of heterogeneous components. Appropriate indices for use in revaluation accounting must be selected carefully.

CURRENT COST ACCOUNTING METHOD

In this method historical price of assets is not considered. On the other hand current price of each item is considered concept of current cost, it is sometimes called 'Replacement Cost'. Current cost can be foundout by following method:

Net Realisable Value : If existing asset is sold on the date of balance sheet what net price will be realised the same is treated as net realisable discounted present value : If a machine is used four years more in future and income of Rs. 20,000 is derived every year from it and per year expenses on this machine are Rs. 6,000, then net income per year is Rs. 14,000. In the next four years net income from this machine will be Rs. 1,40,000 × 4 = 56,000. Its present value is found out after deducting discount. This is known as discounted present value.

❖ Net replacement cost : This is the cost at which concerned asset can be purchased in the market on the date of balancesheet. This method has been explained in Valuation and Accounting of Depreciation chapter no. fifth. Out of the above three methods, net replacement cost method is treated as best.

VALUATION OF ASSETS UNDER CCA

1. **Plant and Machinery :** Plant and machinery are valued on net replacement cost as has been explained earlier.

2. **Self-occupied Land and Buildings:** They are valued on open market price and cost of its acquisition is added in it. Actually its valuation is to made after every five years period by experts and during this period of five years their valuation be made by company's directors on the advice of professional values.

3. **Long period Investment :** Their valuation is made as under :

- If the investments are quoted in stock exchanges, their valuation is made on the price ruling therein.

- The investments, which are not registered in stock exchange, are valued on the basis of current cost, i.e., net asset of that company be found out in which this investment has been made and valuation should be made on the basis of this amount.

4. **Current Investments** : They should be valued as stock.

5. **Stock:** Its replacement cost and net realizable cost on the date of balance sheet be found out and whichever amount is less out of these two, that should be treated as value of stock.

6. **Work-in-progress** : It is valued in the same manner as stock.

- **Current Assets other than Stock and Work in Progress.** These assets are shown at the same amount which appears in historical cost. Their examples are: Cash, B/R and Debtors etc.

- **Current Liabilities:** They are shown at the same amount which appears in historical cost.

COST OF SALES ADJUSTMENT OF COSA

Sales are made at current prices hence there is no need of adjustment of sales, but all elements of cost of sales are not on current cost, hence they are adjusted at current cost. When stock is included in cost of sales, then its adjustments becomes necessary because remaining amounts of cost of sales are at current price. This adjustment is called Cost of Sales Adjustment.

METHOD OF COST OF SALE ADJUSTMENT

Average current cost of closing stock is found out in the following manner :

$$\text{Closing Stock} \times \frac{\text{Average Index Number}}{\text{Closing Index Number}}$$

Average current cost of opening stock is found out in the following manner :

$$\text{Opening Stock} \times \frac{\text{Average Index Number}}{\text{Closing Index Number}}$$

Average Current cost of closing stock— Average current cost of opening stock= Cost of Sales Adjustment.

$$\text{COSA} = (\text{C}{=}\text{O})\ \text{Fa} \left[\frac{\text{C}}{\text{IC}} - \frac{\text{O}}{\text{IO}} \right]$$

COSA = Cost Of Sales Adjustment

C = Historical Cost of Closing Stock

O = Historical Cost of opening Stock

Ia = Average index number for the period

IC = Closing Index number for the period

IO = Opening index number

DEVELOPMENT S ABROAD

Need for inflation accounting has been recognized world over. Thesre has been a very lively debate in 1970s and 1980s which centered around evolving an appropriate method of inflation accounting. In U.K. SSAP-7, Accounting for changes in purchasing power by money' recommended current purchasing power method of accounting. This standard was not mandatory. This was followed by SSAP- 16 accounting standard recommending current cost accounting. This standard was withdrawn in April 1990 on account of strong difference of opinion in the accounting profession.

In USA securities and exchange commission issued ASR- 190 requiring corporations to include current replacement cost disclosure in financial; statement. FASB had issued SFAS no. 33 which was followed by SFAS no. 89 encouraging supplementary disclosures on current cost or constant purchasing power current basis.

In other countries of the world effects have been made to find out an appropriate method for accounting for change in value of money. However, in India except for a guidance note issued by the Institute of Chartered Accountants of India neither the accounting profession nor the Govt., the industry has made any whole hearted effort to evolve an inflation accounting. This is in spite of the fact that problem of inflation is more acute in India than in most of the western countries.

Although the world over debate has taken a respite the need for inflation accounting continues to exist. Various controversial areas remain. The problem of interpreting inflation adjusted accounts, generating norms of debt equity, earning per shares, return on capital etc., have to be tackled. Some of the norms could be quite different from those which the users of accounts are accustomed to under Historical cost accounting problems of investments in foreign countries having separate inflation rate devaluation of currencies and different trends in price rise specific to different industries have also to be satisfactorily dealt with.

These and various other related issues need debate so as to find an acceptable solution. But this can be done only if a beginning is made.

CONCLUSION

Accounting and auditors in developing countries i.e. like our country, where the purchasing power of the currency unit has been decreasing at an appreciable rate face a peculiar problem of professional integrity. If they continue to certify that to the best of their knowledge and belief final accounts in general and values of fixed assets and consequent contribution of their depreciation on the basis of historical costs in particular represent '**TRUE AND FAIR VIEW'** of the affairs of the company even though purchase value of the currency unit has change by way a few hundred per cent by implication; they certify their innocence of their own economic expedience due to changes in money value. This is a rather uncomfortable situation. The situation is a little more difficult for accounts and auditors who have been associated with the company for a few decades over which the purchasing power of currency unit has fallen down appreciable. With significant changes in money values over time, accounts based on historical cost can't appropriately be certified to represent a true and fair view of the affairs of the company.

"Inflation/price level changes accounting involving integration of the sciences of economics and accounting under the developmental environment of complex actual life socio-economic factors in developing economies exposed to violent changes in the purchasing power of their currency unit appears to provide a solution. It can however, be implemented only in conjunction with highly refined techniques of scientific management yet to take concrete shape in the countries.

The accountants and auditors in these developing countries. Therefore face a peculiar Dilemma. They must devise their owm tools and techniques of inflation / price revel changes accounting to face the situation with a clear conscience.

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