EMERGING **TRENDS** in FINANCIAL **DEVELOPMENT** and ECONOMIC **GROWTH**

Editors
Dr. Dhanya Alex
Mr. Jomy Lawrence

THE EDITORS

Dr. Dhanya Alex, Associate Professor, FISAT Business School (Kochi) has 17 years of teaching and research experience. She has been awarded PhD by the Cochin University of Science and Technology and has published several articles in refereed national and international journals. Dr. Dhanya Alex is a trainer for various programmes offered by NSE and SEBI in financial markets and investor education.

Mr. Jomy Lawrence, Senior Assistant Professor, XIME (Kochi) has over 20 years of experience in the tele-communication industry before joining the academics. He has conducted several corporate trainings and has undertaken consultancies. Mr. Jomy has a Bachelor's Degree in Civil Engineering and PGDBA from XIME, Bangalore.

UPANAYAN PUBLICATIONS
772, Street No 6, B Block, Baba Colony, Burari,
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Chapter – 6

Inflation Accounting: A Tool for Measuring The Rate at Which Price Level of Goods and Services Increasing

*Dr. Darshana Deepak Kadwadkar**

Introduction

Inflation Accounting refers to a state in which the purchasing power of money goes down conversely. As a result, there is more money in circulation than is justified by goods and services.

Inflation Accounting involves recording the business transaction at current value to analyse the impact of changes in price or business transaction on companies' cost and revenues, assets, and liabilities. After adjustments, the balance sheet exhibits a suitable position that helps managers make the right decisions. It compares revenues and expenses at current cost for reflecting a realistic position. Inflation accounting presents the company's actual condition by adjusting all price level changes in its financial statements. It depicts a fair view of its financial position by reflecting all changes per the current price index.

In an economic sense, Inflation refers to a quantitative measure of the rate at which the average price level of goods and services increases. Inflation Accounting refers to a state in which the purchasing power of money goes down conversely. There is more money in circulation than is justified by goods and services. The general weakness of the traditional accounting system is that it fails to reflect the price level change in the financial statement based on historical cost.

After adjustments, the balance sheet exhibits a suitable position that helps managers make the right decisions. Finally, it compares revenues and expenses at current cost for reflecting a realistic position.

* K.B. College of Arts and Commerce for Women, Thane

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Historical information on financial statements is no longer applicable when a business operates in a country with a large amount of market inflation or deflation. In some cases, companies can use inflation-adjusted figures to counter this issue, restating the numbers to reflect current economic values. IAS 29 of the International Financial Reporting Standards (IFRS) directs organizations whose functional currency is the hyperinflationary economy's currency. The IFRS describes hyperinflation as rates, debt, and wages linked to a price index that cumulatively rises 100% or more over three years. Companies that fall under this category might require updating their statements periodically to make them relevant to prevailing economic and financial conditions, supplementing cost-based financial statements with regular price-level adjusted statements.

Inflation accounting is a unique method used to weigh on the published statistics of multinational firms in the effects of soaring or plummeting prices of products in some areas of the world. Financial statements are adjusted as per price indexes to paint a clearer picture of a firm's financial position in inflationary environments rather than relying solely on cost accounting. This method is also referred to as price level accounting.

Inflation accounting uses two primary methods, i.e. current purchasing power (CPP) and current cost accounting (CCA).

Current Purchasing Power (CPP) means monetary items and non-monetary items are separated according to the CPP method. The monetary items accounting adjustment is subject to recording a net gain or loss. Non-monetary details are updated into figures with a conversion factor equivalent to the price index at the end of the period divided by the price index at the transaction date.

Under this method, the monetary and non-monetary items are separated with monetary items recording only a net gain or loss. In contrast, the non-monetary items will be updated into figures with a particular conversion factor equivalent to a specific price index.

Conversion factor under CPP method= price at current period price at the Historical Period

Current Cost Accounting (CCA): This method values assets at their Fair Market Value (FMV) rather than at historical cost, the price paid when the fixed asset was purchased. Under the CCA, currency as well as non-monetary items, is restated to current values.

Advantages & Disadvantages

- Much more practical analysis of productivity is given by comparing existing sales to current costs.
- It can confuse investors by providing adjusted figures and allow companies to flag numbers that shine in a better light. The process of changing accounts to a factor in market changes will lead to a constant restatement and alteration of financial statements.

Objectives and Importance of Inflation Accounting

- Inflation accounting exhibits the actual and financial status of the company by reflecting all books of accounts at the current price.
- It adjusts all records following the current price index of determining actual profitability.
- It keeps a check on companies' financial statements to avoid any overstatements of profits.
- It charges the correct amount of depreciation by calculating it on present value instead of historical value.
- It enables firms to compare their inter-periods performance for determining their profitability quickly.
- It provides correct information to shareholders and workers based on the present price level.

Limitations

- The profit and loss account and the balance sheet drawn up based on historical costs do not permit a proper appraisal of the performance of the concern and its financial position.
- The second limitation is faulty decisions that are likely to be made if the costs and profits are not correctly ascertained.

Role of Inflation Accounting

It is essential, but equally important is the question of survival which is bound up intimately with the replacement of assets at the end of their life. It means that the firm must have funds to carry out the replacement when due.

This is one of the critical functions of accounting for depreciation and is quite adequately performed if there is no increase in prices; also, if increases in prices are constantly kept in view while providing depreciation, at least partially.

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The point is that inflation accounting must specifically keep objective in view; otherwise, there is a danger that the firm will be[...] sick simply because it does not have adequate funds to acquire [...] assets when the old assets have yielded all their utility.

If ascertaining real profit and maintenance of operational capab[...] or capital physically are to be viewed separately, this approach m[...] be pretty valid, but to do so will be to take a partial view of the s[...] of affair to the detriment of not only the various interested parties [...] also the firm itself.

The firm should not eat up its capital. Instead, it should ke[...] its ability to replace assets with new ones of equal efficiency wh[...] the time comes is a duty and function of Financial Accounting a[...] Financial Management. Perhaps Financial Accounting has a grea[...] responsibility in this regard since it alone can provide the necess[...] information for the required decisions.

Examples

From the below-given data, compute the net monetary gain or loss [...] per the CCP method.

Monetary items	1/1/2020	31/12/2[...]
Cash	8,000	[illegible]
Debtors	25,000	[illegible]
Public deposits	30,000	[illegible]
Creditors	20,000	[illegible]
Price index		
1/1/2020	100	
31/12/2020	150	
Average for the year	120	

Solution: Monetary gain on holding liabilities

Impact of price level changes on liabilities	
Value of monetary assets on 1/1/2020	[illegible]
Value of liabilities at current prices (Rs. 45,000*150/100)	[illegible]
Value at additional liabilities at current prices (Rs. 60,000-45,000)*150/120	[illegible]
Total current price	[illegible]
Less: value as per closing balance sheet	[illegible]
Monetary gain on holding liabilities	[illegible]

Monetary gain on holding liabilities =Rs. 86,250 – Rs. 60,000 = Rs. 26,250

Where, Value as per closing balance sheet = Credits + Public Deposits = Rs. 60,000

Monetary loss on holding a monetary asset

Impact of price level changes on monetary assets	*Rs*
Value of monetary assets on 1/1/2020	33,000
Value at current prices (Rs. 33,000*150/100)	49,500
Additions at current prices (Rs. 49,500-33,000)*150/120	20,625
Total current price	70,125
Less: value as per closing balance sheet	49,500
Monetary gain on holding liabilities	20,625

Monetary loss on holding monetary asset = Rs70,125 – Rs49,500 = Rs. 20,625

Calculation of Net Monetary Gain is as follows,

Monetary gain on holding liabilities	Rs. 26,250
Monetary loss on holding monetary asset	Rs. 20,625
Net monetary gain	Rs. 5625

Net Monetary gain = Rs. 26,250 -Rs20,625 =Rs.5,625

Conclusion

Historical cost accounting does not disclose actual profit that can maintain its capital. The growing dissatisfaction with historical cost accounting as a method of reporting financial statements has made it necessary to consider alternative methods accounting for price level changes. It accounts for price level changes put as inflation accounting reports financial activities by adjusting historical cost values with the effect of Inflation mainly through inflation indices and the market price of assets. Many people have raised many concerns such as its complexity, subjectivity, cost, and the use of indices. Inflation Accounting provides a breeding ground for creative accounting due to its judgemental nature to the disadvantage of the innocent investor.

Inflation accounting, no doubt, reflects the actual value of the business but suffers from certain drawbacks such as non-acceptance by authorities or complications involved in the systems and process.

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However, the real purpose of a financial statement is to provide accurate and fair value to the business. The income statement must show the business's true and accurate profit or loss during a specific period. The balance sheet must reflect the fair and accurate financial position again.

Since they are represented in monetary value, and currency money fluctuates regularly, it becomes necessary that a method such as inflation accounting serves its purpose by enabling the financial statements to reflect such true and fair value accordingly. This method thus ensures that there will be no significant deviations on the part of the business.

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