

Inflation Accounting: Unveiling the Conceptual Information and Impact on Financial Ratios

Ashish P. Chirodiya
(JRF & PhD Scholar)

Department of Commerce and Business Administration,
Saurashtra University,
Rajkot.

E-mail: ashishchirodiya01@gmail.com

ORCID ID: 0000-0003-4230-7652

Abstract: This paper explores the conceptual part of inflation accounting technique. First of all it clarifies the meaning of Inflation accounting. Then it provides various forms or types or methods of calculating Inflation accounting. Then it gives an idea about how Inflation accounting impacts the various financial ratios like profitability ratios, Liquidity Ratios etc. Which are very important to know the financial performance of any company. After that this paper also give information about various strategically important decisions that are taken on the basis of inflation accounting. At the end of the paper, it summarizes the advantages and disadvantages of inflation accounting.

Keywords: Inflation Accounting, CCA, GPLA, Profitability, Liquidity

• Meaning of Inflation Accounting

Inflation accounting is an accounting method that adjusts financial statements to account for the effects of inflation on the financial performance and position of a company. Traditional accounting measures financial performance based on historical costs, which can be misleading during periods of inflation. Inflation accounting aims to provide a more accurate reflection of a company's financial health by adjusting monetary values to reflect current prices, enabling stakeholders to make better-informed decisions.

• Types/ Methods for Calculation of Inflation Accounting

There are several methods used in inflation accounting:

1. Current Cost Accounting (CCA):

Involves adjusting the value of assets and liabilities to their current replacement costs. This method reflects the amount that would need to be paid to replace an asset at today's prices, thereby providing a more realistic view of the company's worth.

2. General Price Level Accounting (GPLA):

Adjusts financial statements based on changes in a general price index, such as the Consumer Price Index (CPI). This approach aims to maintain the purchasing power of financial statements and allows for comparisons over time without the distortion of inflation.

3. Restated Financial Statements:

Historical financial statements are restated to reflect inflation effects. This involves adjusting revenues, expenses, and capital costs based on a designated inflation index.

4. Constant Dollar Accounting:

All amounts in the financial statements are expressed in terms of a specific purchasing power unit (i.e., dollar value adjusted for inflation). This method allows for direct year on year comparisons, reflecting the true economic reality.

• Impact of Inflation Accounting on Financial Ratios

1. Profitability Ratios

- **Gross Profit Margin:** Inflation accounting adjusts revenue and cost of goods sold to reflect current prices. This adjustment can reveal a more accurate gross profit margin by accounting for actual purchasing power, especially if costs increase significantly without a corresponding increase in selling prices.
- **Net Profit Margin:** Similarly, net profits adjusted for inflation provide a realistic view of profitability. Historical costs may understate expenses, leading to overstated margins. Correcting this allows for a more accurate assessment of a company's operational efficiency.

2. Return Ratios

- **Return on Assets (ROA):** Inflation accounting provides a truer depiction of asset values by adjusting for current costs. This adjustment can lead to a different ROA calculation, indicating how effectively a company generates profit from its assets.
- **Return on Equity (ROE):** Just as with ROA, adjusting net income for inflation provides a clearer picture of profitability relative to shareholder equity. ROE using inflated historical costs may artificially inflate performance metrics.

3. Liquidity Ratios

- **Current Ratio:** When liabilities are adjusted to account for inflation, the current ratio may change, revealing insights into a company's liquidity position. For example, if current liabilities are adjusted upward without corresponding adjustments in current assets, the ratio may decrease, indicating weaker liquidity.
- **Quick Ratio:** Similar to the current ratio, this indicator's value can shift substantially based on how inflation adjustments are made for inventory and other short-term assets.

4. Efficiency Ratios

- **Asset Turnover Ratio:** This ratio measures how effectively a company uses its assets to generate revenue. When asset values are adjusted for inflation, the ratio may reflect a more realistic efficiency level. If inflated costs are not considered, the ratio may depict an inaccurate operational effectiveness.

- **Inventory Turnover Ratio:** Adjustments for inflation can provide insights into whether inventory levels are being efficiently managed. If the cost of inventory is rising significantly, traditional accounting methods may not represent inventory effectiveness accurately.

5. Leverage Ratios

- **Debt to Equity Ratio:** Adjustments in asset valuations can affect this ratio. If assets are inflated without similar adjustments in equity, the ratio may indicate a higher degree of leverage, potentially affecting perceptions of financial stability.
- **Interest Coverage Ratio:** With inflation accounting, interest expenses may be more accurately represented, impacting how well a company can cover its interest obligations. A clearer picture of operating income as adjusted for inflation can lead to more prudent assessments of solvency.

6. Market Ratios

- **Price to Earnings (P/E) Ratio:** Inflation accounting provides a more accurate earnings figure, which can drastically shift the P/E ratio. An inflated historical earnings figure could cause a misleadingly low P/E ratio, suggesting that a stock is undervalued when, in reality, it reflects old cost structures.
- **Earnings Per Share (EPS):** Similar to P/E, EPS may change when inflation adjustments are made to net income. A more realistic EPS can influence investor perceptions and market valuations significantly.

• Implications for Analysis

- **Investment Decisions:** Investors must consider the impact of inflation accounting when analyzing these ratios, as traditional calculations may not provide an accurate view of a company's real financial position or operational efficiency.
- **Comparability:** It may pose challenges in comparing financial ratios across companies, especially if some firms apply inflation accounting while others do not. This inconsistency can distort performance assessments and peer evaluations.
- **Forecasting and Business Strategy:** Understanding how inflation accounting affects financial ratios can guide businesses in setting realistic goals and strategies while preparing for potential inflationary trends in the future.

The impact of inflation accounting on financial ratios is significant and multifaceted. By adjusting financial statements for inflation, ratios provide a more accurate representation of a company's financial health and performance. Stakeholders, including investors and analysts, must understand these adjustments to make well informed decisions, ensuring that their evaluations reflect a company's true economic realities.

• Importance of Inflation Accounting

1. More Accurate Financial Representation:

Provides a clearer picture of a company's profitability and financial position by avoiding historical cost distortions.

2. Informed Decision Making:

Offers investors, creditors, and management a better basis for making decisions, especially when assessing the performance of assets and profitability.

3. Enhanced Comparability:

Facilitates meaningful comparisons across different time periods, helping stakeholders analyze trends without inflation skewing data.

4. Better Resource Allocation:

Enables management to make smarter operational and investment decisions by recognizing the purchasing power of revenues and costs.

5. Compliance with Regulations:

Some jurisdictions may require or encourage inflation accounting, especially in economies experiencing hyperinflation.

• Disadvantages of Inflation Accounting

1. Complexity:

Implementing inflation accounting methods can be complicated, requiring extensive adjustments and additional records, which may overwhelm some companies, especially smaller ones.

2. Subjectivity in Measurements:

Methods like Current Cost Accounting involve subjective judgments about replacement costs, which may result in inconsistent or disputable valuations.

3. Adjustment Issues:

Determining the appropriate inflation index, whether for GPLA or other methods, can be contentious and may lead to discrepancies in reporting.

4. Reduced Comparability:

Different companies may apply different inflation accounting methods, complicating the process of comparing financial performance across firms in the same industry.

5. Limited Adoption:

Many companies may resist adopting inflation accounting due to the additional workload and complication, opting instead to maintain traditional methods even in inflationary environments.

• Conclusion

Inflation accounting plays an essential role in modern financial reporting, particularly in economies experiencing inflationary pressures. By adjusting financial statements to reflect changes in purchasing power, companies can present a more accurate and fair assessment of

their financial performance. While it has undeniable benefits, businesses must also navigate complexities and potential subjectivity involved in its implementation. Therefore, understanding both the advantages and disadvantages of inflation accounting is crucial for stakeholders aiming to make informed economic decisions.

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