

CONSEQUENCES OF THE INFLATION OVER THE CONTINUITY OF ENTERPRISES' ACTIVITY

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In conditions of inflation, the historical costs accounting, related to a basic principle of accountancy, that is the caution principle, lead to the enterprises decapitalization, with serious consequences over the continuity of the activity in conditions of economic efficiency. Therefore, finding new alternatives which could lead to the removal of this deficiency in the traditional accounting model, in conditions of inflation, is an imperative. In this context, the major objective of the firms that carry on their activity in an inflationist environment is to maintain their capital, as well as to secure a profit which can ensure the maintenance of the capital, the continuity of the activity depending mainly of its fulfillment.

Key words: inflation, financial capital, physical capital

The inflation is a self sustained phenomenon of an overall price increase, which affects the economy of a state, having important implications not only at an economical level, but also to the social one. The inflation has as effect the corrosion in time of money value, as well as the sustained price growth in economy.

In most countries, the financial statements are produced on the basis of the historical costs, without taking into account the changes of the overall price level or the individual change of the owned assets prices, except for the fixed assets, that were reassessed. Thus, the assets elements, the capital accounts, the debts, the incomes and the expenses are expressed in accordance with the value existing at the date when these elements appeared. The impact of the inflation is consequently ignored.

The inflationist phenomenon distorts the accounting information presented through the financial statements in two ways:

- it diminishes the accounting information's capital accounts;
- it over values the results of the accounting period;

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The distinction between profit and capital is extremely important in inflationist conditions. As long as the source of obtaining the profit is the capital, this one can not be consumed without affecting the future profits. So, the capital must remain intact in order to be able to produce the same profit level.

"In general terms, an enterprise maintained its capital if at the end of the period, it has a capital that is equal tot the one from the beginning of the period. Any other supplementary value besides the needed one in order to maintain the level from the beginning of the period is considered to be profit."³¹⁶

"The concept of capital preservation decides the extent to which an enterprise can allot the accruals obtained during the year without prejudicing its future"³¹⁷.

Consequently, the profit is the maximum value that an enterprise can allot during the year, so that it can preserve intact the capital owned at the beginning of the period.

³¹⁶ General Framework for the Preparation and Presentation of Financial Statements issued by the International Accounting Standards Board, pct. 107, overtaken in OPFM no. 94/2001 (O.G. no. 85/20.02.2001)

³¹⁷ Lavinia Olimid, Măsurarea rezultatului contabil, Economic Publishing House, Bucharest, 1998, page 60

Within an economy which is not affected by inflation, the profit obtained at the end of the period represents the real profit, and it can be consumed entirely, without the fear of impoverishing the capital. The capital is expressed in the same monetary units as at the beginning of the period and remains intact during all this time.

But in an inflationist environment, taking into account the fact that the incomes are expressed in real monetary units (in terms of the value of money from the moment of their recognition), and the expenses which are to be connected to these incomes are expressed in nominal monetary units (in terms of the value of money from the moment of achieving the assets which generated the expense), in order to find the real profit and to compute an unitary result of the activity, the expenses must be expressed in real monetary units.

The overall expenses adjusted to inflation will represent the sum of the value of expenses expressed in nominal monetary unit, and the price variations between the real monetary unit the nominal one due to the assets which generated the respective expenses.

Therefore:

$Cr = Cn + v$ where:

Cr – expenses expressed in real monetary units,

Cn – expenses expressed in nominal monetary units;

v – price variations due to the assets.

The real profit will be:

$Pr = V - Cn - v$

The historical costs profit (Pci) will represent the sum of the real profit and this price variations, which is in fact the gain resulting from the owning of the assets that generated the expense.

$Pci = Pr + v$

This owning gain represents the sum that needs to be invested in the enterprise, so that the capital level stays the same. In other words, the existence of the owning gain determines the issue of the capital preservation concept.

The question is: *this owning gain must be regarded as a constitutive part of the profit which is to be distributed later on, or as an element of the capital account under the form of a resource?*

The answer to this question can be found depending on the means of capital measurement. From the point of view of the desired objective of the enterprise, there are two perspectives regarding the capital measurement:

- the owner's (shareholders)
- the enterprise's

1. The owner's capital (financial) and its maintain

The owner's capital is found in the specialty literature under the name of financial capital. The paragraph 102 from the Conceptual Framework IASB defines the financial capital: "the financial capital is synonym with the net assets or with the entity's capital account".

The concept of financial capital maintain is defined in the paragraph 104 from the Conceptual Framework IASC³¹⁸, where it is specified that "according to this concept, the profit is secured only if the financial value of the net assets at the end of the period is higher then the financial value of the net assets from the beginning of the period, after the exclusion of all distribution towards the owners and of any contributions of the owners during the analyzed period."

In other words, the increase of the assets value, which exceeds the overall price increase, is to be recognized as profit.

The preservation of the financial capital can be measured in nominal monetary units, by using the concept of nominal financial capital or stable value of money, through the real financial capital.

³¹⁸ General Framework for the Preparation and Presentation of Financial Statements issued by the IASC Board and adopted IASB, International Financial Reporting Standards, page 54, CECCAR Publishing House, Bucharest, 2005

When the prices are stable, we can talk about the preservation of the nominal financial capital. The sharable profit represents the difference between the capital accounts existing at the end of the period and those from the beginning of the period, taking into account the possible capital increases or decreases which appeared during the year due to the owners` contributions or withdrawals.

When the prices are variable, the term of real financial capital becomes operational. As the preservation of the nominal capital becomes insufficient, the capital accounts from the beginning of the accounting period are adjusted according to the variation of the overall price index in order to preserve the real capital.

The financial concept of the capital must be adopted if the users of the financial statements are concerned mainly with maintaining the invested nominal capital or maintaining the value of the invested capital.

According to this concept, the profit is recognized only after the value of the capital accounts is maintained. All the adjustments that need to be done to the financial statements, so that the enterprise's financial capital (capital account or the net assets) stay stable, are the objectives of the conversion based methods (methods based upon the current value of money). This methods aim to adjust the financial statements expressed in nominal unitary methods, with the purpose of expressing them in stable monetary units , and also the quantification of the result owned to the national currency depreciation.

In order to exemplify the above mentioned, let's take the following hypothetical example:

At the beginning of the N accounting period, an enterprise has a share capital of 300 m.u., representing a building with the value of 200 m.u., stocks in value of 80 m.u. (40 pieces * 2 m.u./piece) and money supply in value of 20 m.u. The building is subjected to a straight-line amortization for a remaining period of 20 years. At the end of the N accounting period, the enterprise sells 20 pieces of stock at the price of 3m.u./piece.

During the N period, the overall price increase was of 20%.

(Historical costs) Balance sheet at the 1st of January N

Table no. 1

Fixed assets	200 m.u.	Share capital	300 m.u.
Stocks (40 pieces*2 m.u./piece)	80 m.u.		
Money supply	20 m.u.		
Total assets	300 m.u.	Total liabilities	300 m.u.

Loss and gain account at the 31st of December N

Table no. 2

Elements	In historical costs	In historical costs modified depending on the evolution of the overall value of money
Sales incomes	60 m.u. (20*3 m.u.)	60 m.u. (20*3 m.u.)
- the cost of the sold stocks	-40 m.u. (20*2 m.u.)	-48 m.u. (40*1,2)
- the building amortization	-10m.u. (200*5%/year)	-12 m.u. (10*1,2)
Losses from owning monetary elements (money supply)		-4 m.u. (20*0,2)
Profit	10 m.u.	-4 m.u.

The balance sheet from the end of the N accounting period expressed in current value of money will be:

Balance sheet at the 31st of December N

Table

no. 3

Gross fixed assets (200*1,2)	240 m.u.		
- amortization	-12 m.u.	Share capital (300*1,2)	360 m.u.
Net fixed assets	228 m.u.		
Stocks (40*1,2)	48 m.u.	Profit/Loss	- 4 m.u.
Money supply (20 + 20*3 m.u)	80 m.u.		
Total assets	356 m.u.	Total liabilities	356 m.u.

The real profit computed as a difference between the capital accounts from the end of the accounting period and the capital accounts from the beginning of the accounting period adjusted with the overall price index is:

$$Pr = 356 \text{ m.u.} - 300 \text{ m.u.} * 1,2$$

$$Pr = -4 \text{ m.u.}$$

The monetary elements (cash assets and debts) stay recorded at their nominal value in the financial statements from the end of the accounting period. The difference between them will determine the gain/loss from owning monetary elements, which will appear as a different position in the loss and gain account.

In what concerns the non monetary elements, these will be recorded in the financial statement at their new value adjusted in counter trade with an element of expenses or incomes, from case to case, for the adjustments of the current year, and a resources account for the adjustments of the previous years.

In conclusion, the adjustment of the financial capital, with the purpose of its maintenance, will be done through the overall prices index. This perspective admits the effect of the inflation over the patrimonial monetary and non monetary elements as a component of the enterprise's result.

2. The enterprise's capital (physical) and its maintain

The general framework IASB defines in the paragraph 102 the concept of physical capital or "the exploitation capacity" as it follows: "*the capital represents the production capacity of the enterprise expressed, for instance, in production units per day*".

The concept of maintaining the physical capital is defined in the paragraph 104 as it follows: "*according to this concept, the profit is secured only when the productive physical capacity (exploitation capacity) of the enterprise at the end of the period surpasses the productive physical capacity from the beginning of the period, after the exclusion of all distribution towards the owners and of any contributions of the owners during the analyzed period.*"

The profit determined on the basis of the historical cost does not make the distinction between the profit resulting from exploitation and the profit resulting from owning goods whose current cost is higher than the cost to which they were achieved. These owning gains are not gains obtained during the maintenance of the goods in enterprise's possession, and when they are to be sold, they will be entirely recognized in the gains and losses account, even if they are due to more accounting periods.

The concept of maintaining the physical capital decides the extent to which these gains are included in the sharable profit. With the purpose of maintaining the productive capacity of the enterprise, the increase of the assets value, and the latent additional value, will be recorded in the resources category, in a distinct account "adjustment reserves". The maintenance of the enterprise's physical capital is possible only if these reserves are not sharable.

With the purpose of establishing the production capacity which needs to be maintained, the goods that are used within the production process (fixed assets and stocks) must be expressed in current values, and also in values into which they can exchange at a certain point using real basis.

Among the assessment bases which can be used in the assessment of the financial statements (historical cost, current cost, realizable value and present value), the current cost, the realizable value and the present value can be considered as forms of the current value.

As it is determined based on some objective values (book value, specific price index), the current cost is the assessment base used the most often in order to express the present value of the goods. *The current cost* is the delivered cost of an equivalent new good, to which a rectification for depreciation is applied. The current cost can also be determined by multiplying the book value of the good with a price index specific to that category of goods.

Starting from the previous numerical example and knowing that, at the end of the accounting period, the stocks replacing cost is of 2, 5 m.u./piece (it grew with 25% from the beginning of the period), and the replacing cost of the fixed assets is of 240 m.u. (it grew with 20% from the beginning of the period), the financial statements will be retreated with the purpose of maintaining the physical capital as it follows:

Loss and gain account at the 31st of December N

Table no. 4

Elements	In historical costs	<i>In current costs</i>
Sales incomes	60 m.u. (20*3 u.m.)	60 m.u. (20*3 m.u.)
- the cost of the sold stocks	-40 m.u. (20*2 m.u.)	-50 m.u. (20*2,5 m.u.)
- the building amortization	-10 m.u. (200*5%/year)	-12 m.u. (240*5%/year)
Profit	10 m.u.	-2 m.u.

Determining the capital gains

Table no. 5

Realized yield from the sold stocks owning (20*(2,5-2))	10 m.u.
Realized yield from the building owning – interest from yearly amortisation ((240-200)*5%/year)	2 m.u.
Unrealized yield from the unsold stocks owning (20*(2,5-2))	10 m.u.
Unrealized yield from building owning ((240-200)-2)	38 m.u.
Total owning income	60 m.u.

The balance sheet of the N period, expressed in current costs is:

Balance sheet at the 31st of December N

Table no. 6

Gross fixed assets	240m.u.	Share capital	300 m.u.
-amortization (240*5%/year)	-12 m.u.	Profit/Loss	
Net fixed assets	228 m.u.	Reserves of capital	-2 m.u.
Stocks (20*2,5 m.u.)	50 m.u.	maintaining	60 m.u.
Money supply (20+20*3m.u.)	80 m.u.		
Total assets	358 m.u.	Total liabilities	358 m.u.

The real profit, computed as the difference between the capital account from the end of the accounting period and the capital accounts from the beginning of the accounting period, adjusted with specific price index of the non monetary assets, is:

$$Pr = 358 \text{ m.u.} - (200 \text{ m.u.} * 1, 2 + 80 \text{ m.u.} * 1, 25 + 20)$$

Pr = -2 m.u.

The non monetary assets are presented in the balance sheet at present value, and the profit will be recognized by the enterprise only after its operational capacity was maintained.

The adjustments made to the financial statements with the purpose of maintaining the enterprise's production capacity, represent the objectives of the assessment based methods (current costs based methods). These methods are oriented towards the usage of the specific index for the value correction of different categories of goods, of the amortisements and of the sales cost.

In conclusion, the maintenance of the enterprise's physical capital is done through the specific price index of the non monetary assets, recognizing the profit only after the capital was maintained.

3. The maintenance of the owners' and enterprise's capital

As resulting from those mentioned above, the adjustments made in order to maintain the financial capital do not take into account the fact that most prices of certain goods can surpass the overall price changes, and this prejudices the maintenance of the physical capital.

Moreover, with the purpose of maintaining the physical capital the inflation impact is quantified only in the case of non monetary assets, without taking into consideration the influence that the inflation has over the monetary elements of the enterprise, and this way, the complete maintenance of the financial capital is not ensured.

In order to maintain the financial capital, as well as the physical capital, the profit must be corrected with the gain or with the loss from monetary elements owning and diminished with the gain owed to the value increase of the non monetary assets over an overall price increase.

In the balance sheet, the non monetary assets are to be presented to an adjusted value, adjustment made through the overall price index or through the specific price index, depending on which one is higher, and the non monetary liabilities are to be adjusted through the overall price index. The monetary elements will stay recorded in the balance sheet at their nominal value.

The gains resulting from the non monetary assets owning, whose specific price index surpasses the overall price index, will be recorded under the form of non sharable reserves, which will rise the enterprise's capital accounts.

With the purpose of preserving the financial and the physical capital, the capital accounts from the beginning of the accounting period are to be adjusted with the overall price index, except for the non monetary assets whose prices are higher than the overall prices increase, which are to be adjusted through the specific price index to the respective assets.

Starting from the same numerical example, the financial statements adjusted with the purpose of maintaining the financial capital, as well as the physical capital, are as it follows:

Loss and gain account at the 31st of December

Table no. 7

Elements	In historical costs	In historical costs adjusted with the purpose of maintaining the physical capital and the financial capital
Sales incomes	60 m.u. (20*3 m.u.)	60 m.u. (20*3 m.u.)
- the cost of the sold stocks	-40 m.u. (20*2 m.u.)	-50 m.u. (20*2,5m.u.)
- the building amortization	-10m.u. (200*5%/year)	-12 m.u. (10*1,2)
Losses from owning monetary elements (money supply)		-4 m.u. (20*0,2)
Profit	10 m.u.	-6 m.u.

Determining the capital gains

Realized yield from the sold stocks owning (20*2,5-40*1,2)	2 m.u.
Unrealized yield from the unsold stocks owning (20*2,5-20*2*1,2)	2 m.u.
Total owning income	4 m.u.

Table no.8

Balance sheet at the 31st of December N

Table no. 9

Gross fixed assets	240m.u.		
-amortization (240*5%/year)	-12 m.u.	Share capital(300*1,2)	360 m.u.
Net fixed assets	228 m.u.	Profit/Loss	- 6 m.u.
Stocks (20*2,5 m.u)	50 m.u.	Reserves of capital	4 m.u.
Money supply (20+20*3m.u.)	80 m.u.	maintaining	
Total assets	358 m.u.	Total liabilities	358 m.u.

$$Pr = 358 - (200*1,2+80*1,25+20*1,2)$$

$$Pr = -6 \text{ m.u.}$$

The capital accounts from the end of the accounting period expressed in real monetary units are of 358 m.u, and those from the beginning of the accounting period, adjusted with the purpose of expressing them in real monetary units are of 364 m.u., the difference between them representing the real loss, of 6 m.u.

If we compare the historical costs accounting system with the three accounting systems which have as purpose the maintenance of the capital in inflation conditions, we can see that historical costs profit is of 10 m.u., which is equal to a 4 m.u. loss if the financial capital is maintained, a 2 m.u. loss if the objective was the maintenance of the enterprise's production capacity and a 6 m.u. loss if the objective was the maintenance of the owners' capital, as well as of the enterprise's capital.

The choice of one of the capital preservation concepts is motivated by the requirements of the accounting information users, as well as their interest in maintaining the financial power of the invested capital or the operational capacity of the enterprise.

The maintenance of the financial capital is mainly preferred by owners, as it leads to the attainment of a maximum profit and to the maintenance of the capital value.

The physical concept of capital preservation is more attractive for an enterprise' managers and employees, which can consider that the objective of an enterprise is to perpetuate its existence, by providing future goods and services similar to those in the present.

Even if the enterprise's main objective is to maintain the physical capital, as the prices increase, the physical capital needs a higher financial capital, and this capital can be achieved by reinvesting the profit from the previous years or it can be brought by shareholders.

We can conclude that the objective which should be followed is to maintain the owners' possession in an inflationist environment and to maximize it, and this objective is also in compliance with the employees' requirements (jobs availability, safe wages, etc). This thing is to be achieved by the implementation of the inflation adjustment procedures of the enterprise's financial statements items.

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