



## A STUDY ON INFLATION ACCOUNTING AND ITS EFFECT ON FINANCIAL STATEMENTS

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### Abstract

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*Inflation significantly affects financial reporting and decision-making by reducing purchasing power over time. Traditional historical cost accounting records transactions at original values, which ensures simplicity but often fails to reflect current economic reality during rising prices. This can lead to distorted profits, undervalued assets, and misleading financial ratios. This study examines inflation accounting, its methods, and its impact on financial statements. It analyzes how inflation distorts reported performance and evaluates inflation-adjusted accounting techniques in improving accuracy. The study also highlights relevance in hyperinflationary economies and discusses standards such as IAS 29 issued by the International Accounting Standards Board. Overall, it emphasizes the need for more realistic reporting to support better financial analysis and decision-making in changing price environments globally relevant.*

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**Keywords:** *Inflation Accounting, Financial Statements, Historical Cost Accounting, IAS 29, Inflation Impact*

### Introduction:

Inflation is defined as a persistent and continuous rise in the general price level of goods and services in an economy over a period of time. As inflation increases, the purchasing power of money declines, meaning that each unit of currency can buy fewer goods and services than before. This economic phenomenon affects individuals, businesses, and governments by

influencing production costs, consumption patterns, savings, investments, and overall financial stability.

In accounting, financial statements are traditionally prepared using the historical cost convention. Under this system, assets, liabilities, revenues, and expenses are recorded at their original purchase price at the time of transaction. Although historical cost accounting is widely accepted due to its simplicity, reliability, and objectivity, it does not consider changes in the value of money over time. During inflationary periods, this limitation becomes significant, as it may lead to distorted financial results such as overstated profits, undervalued assets, and misleading financial ratios. As a result, the reported financial position may not represent the true economic reality of an organization.

Inflation accounting emerged as a solution to these limitations. It refers to accounting techniques that adjust financial statements to reflect changes in price levels or the purchasing power of money. The main objective of inflation accounting is to present a more realistic and fair view of a company's financial performance and position. It ensures that assets are valued closer to current replacement cost, depreciation reflects current economic conditions, profits are not artificially inflated, and capital is maintained in real terms. In highly inflationary economies, inflation-adjusted reporting becomes essential, and standards such as IAS 29 issued by the International Accounting Standards Board guide this process.

In essence, inflation accounting improves the relevance of financial reporting by bridging the gap between historical figures and current economic value, thereby supporting better decision-making for stakeholders.

### **History and Development of Inflation Accounting**

The development of inflation accounting is closely linked to periods of economic instability and rising price levels across the world. During times of stable prices, historical cost accounting was considered adequate. However, with recurring inflationary pressures, the limitations of this system became increasingly evident, leading to the evolution of inflation accounting concepts.

In the early development stage (1900–1930), inflation was generally low and stable, so historical cost accounting remained widely accepted. However, after World War I, several countries experienced severe inflation, most notably Germany in 1923. During this hyperinflationary period, currency value declined rapidly, making financial statements

unreliable. Companies reported profits that were not real, often referred to as “illusionary profits,” highlighting the urgent need for inflation-adjusted accounting methods.

During the Great Depression of the 1930s, price instability again affected economic systems. This period led economists and accountants to explore alternative approaches such as replacement cost accounting, purchasing power adjustments, and price index methods. However, no standardized global system was adopted at that time.

The post-World War II era (1940–1960) saw continued inflation in many economies, encouraging further research into inflation accounting. Concepts such as Current Cost Accounting (CCA) and General Price Level Accounting (GPLA) were developed, and professional accounting bodies began issuing studies on inflation-adjusted reporting.

The 1970s marked a major turning point due to global inflation triggered by the oil crisis of 1973. Countries like the United Kingdom introduced Current Cost Accounting guidelines, encouraging companies to report assets at replacement cost. In the United States, the Financial Accounting Standards Board issued SFAS 33 in 1979, requiring supplementary disclosure of inflation-adjusted financial information. However, these requirements were later withdrawn due to complexity and declining inflation levels.

Internationally, IAS 15 (1981) was introduced to address changing price levels, but it was later replaced. The most significant development came with IAS 29 (1989), which established a formal framework for financial reporting in hyperinflationary economies. Under IAS 29, financial statements must be restated using a general price index to reflect current purchasing power, and this standard remains part of IFRS today.

In India, inflation accounting is not fully mandatory under normal conditions. However, the Institute of Chartered Accountants of India has issued guidance, and Indian Accounting Standards (Ind AS 29) align with IAS 29 for hyperinflationary situations.

In the modern era, most countries continue to use historical cost accounting, with inflation accounting applied mainly in hyperinflationary economies such as Argentina, Zimbabwe, and Venezuela. At the same time, global accounting practices are gradually moving toward fair value measurement to improve the relevance of financial reporting in changing economic conditions.

### **Research Methodology**

The present study on “**Inflation Accounting and Its Effect on Financial Statements**” is based on a descriptive research design. The descriptive approach is used because it helps in explaining

the concept of inflation accounting, its development, and its impact on financial reporting in a systematic manner. The study mainly focuses **on understanding how inflation influences financial statements** prepared under the historical cost system and how inflation-adjusted accounting methods improve the accuracy of financial information.

The data used in this study is primarily secondary in nature. It has been collected from various reliable sources such as accounting textbooks, academic journals, research articles, reports issued by accounting bodies, and international financial reporting standards like **IAS 29 and IFRS guidelines**. In addition, online publications and economic reports related to inflation and financial reporting have also been referred to for better understanding and analysis of the topic. For analysis, a qualitative method has been adopted. The study compares historical cost accounting with inflation accounting to evaluate their effectiveness in different economic conditions. It also examines the relevance of inflation-adjusted financial statements in hyperinflationary economies. The research can involve primary data or secondary data collection, on conceptual interpretation and theoretical analysis to draw meaningful conclusions.

### **Results and Discussion**

The data interpretation shows that most respondents have a clear understanding of inflation accounting and its importance in financial reporting. The majority agree that inflation accounting helps improve the accuracy of financial statements, particularly by adjusting profits, asset values, and financial ratios. It is also observed that the Balance Sheet is considered the most affected financial statement, indicating that respondents strongly associate inflation adjustments with asset and liability valuation.

The findings also reveal that Current Purchasing Power (CPP) is the most commonly preferred method of inflation accounting. Respondents believe that inflation accounting mainly benefits investors and creditors by providing more realistic financial information for decision-making. Furthermore, most respondents feel that inflation accounting improves comparability, financial analysis, and decision-making quality. However, some inconsistencies are observed in responses related to its impact on profits, depreciation, and tax liability, indicating partial confusion or limited technical understanding among respondents.

**Used some graphs so clear to Result of the study:**

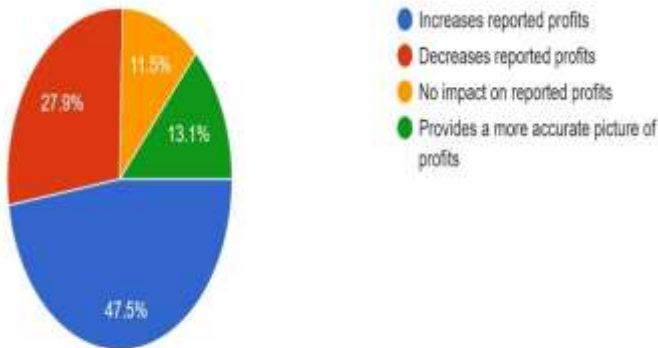
**About the inflation accounting:**



The pie chart shows that increased profitability (41%) is the main perceived benefit of inflation accounting, followed by improved financial analysis (27.9%) and enhanced comparability (16.4%), while reduced tax liability (14.8%) is least important.

Regarding financial statements, the Balance Sheet (54.1%) is considered most affected by inflation accounting, followed by the Income Statement (21.3%) and Cash Flow Statement (13.1%). A small portion (11.5%) believes all financial statements are equally affected.

**Inflation accounting impact profit measurement**



Nearly half of respondents (47.5%) believe inflation accounting increases reported profits, indicating a perception of improved financial performance. A significant portion (27.9%) feel it decreases profits due to higher costs and depreciation effects. Only 13.1%

correctly understand that it provides a more accurate picture of profits. Meanwhile, 11.5% believe it has no impact, showing limited awareness of its actual effect.

**Conclusion**

Overall, the results suggest that while awareness of inflation accounting is fairly strong, deeper conceptual clarity is still required, especially regarding technical effects on financial statements.

The study concludes that inflation accounting plays a significant role in improving the relevance and reliability of financial reporting in an inflationary environment. Traditional

historical cost accounting is widely seen as insufficient during periods of rising prices, as it fails to reflect the real economic value of assets, profits, and liabilities. Inflation accounting methods such as CPP and CCA are considered more useful because they provide adjusted and realistic financial information.

From the responses, it is clear that stakeholders, especially investors and creditors, benefit the most from inflation-adjusted financial statements as they support better investment and lending decisions. The study also highlights that inflation accounting improves comparability, enhances financial analysis, and supports more accurate decision-making. However, its implementation is challenged by complexity in calculations, lack of reliable data, and limited awareness among users.

In conclusion, inflation accounting is an important advancement in financial reporting, particularly for economies facing inflationary pressures. Although it is not widely practiced in all countries, its relevance is increasing with changing global economic conditions. Greater awareness, training, and standardization are needed to improve its practical application and effectiveness in the future.

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