



REVISITING FINANCIAL REALITY: A COMPREHENSIVE STUDY ON INFLATION ACCOUNTING AND ITS PRACTICAL CHALLENGES IN MODERN BUSINESSES

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Abstract

Inflation is a continuous rise in price levels that significantly impacts financial reporting and business decisions. Conventional accounting methods based on historical cost often fail to present a realistic financial position during inflationary periods. This study explores the concept, significance, and practical issues of inflation accounting in the current business environment. It uses a combination of primary and secondary data to assess its applicability. Primary data was collected through questionnaires administered to accounting professionals and small business owners, while secondary data was gathered from books, journals, and financial records. The results indicate that inflation accounting improves the reliability and relevance of financial statements by adjusting for changing price levels. However, its adoption is restricted due to factors such as complexity, high implementation cost, absence of standardized guidelines, and organizational reluctance. The study concludes that although inflation accounting is conceptually valuable, its practical use remains limited, especially among small and medium enterprises, requiring simplified methods and institutional support.

Keywords: Inflation Accounting, Purchasing Power, Financial Reporting, Current Cost Accounting, Price Index, Capital Maintenance, CPI

1. Introduction

Inflation is defined as a sustained increase in the general price level of goods and services in an economy over a period of time. As inflation rises, the purchasing power of money declines, meaning that a given amount of money can buy fewer goods and services than before. This phenomenon has significant implications for businesses, investors, and policymakers, particularly in the area of financial reporting and decision-making.

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Traditional accounting systems are primarily based on the historical cost concept, which records assets and transactions at their original purchase value. While this method ensures objectivity and simplicity, it assumes that the value of money remains constant over time. However, in periods of inflation, this assumption becomes unrealistic, as financial statements prepared under historical cost accounting may present distorted and misleading information. For instance, profits may be overstated due to undervalued expenses, and assets may not reflect their true current worth.

To address these limitations, the concept of inflation accounting was introduced. Inflation accounting involves adjusting financial statements to account for changes in the price level, thereby providing a more accurate and meaningful representation of a firm's financial position and performance. It enhances comparability across accounting periods and supports better managerial decision-making. Two commonly used methods in this approach are the Current Purchasing Power (CPP) method, which adjusts figures based on general price indices, and the Current Cost Accounting (CCA) method, which reflects the current replacement cost of assets. Despite its theoretical advantages, the practical application of inflation accounting faces several challenges. These include the complexity of calculations, difficulty in selecting appropriate price indices, lack of globally accepted standards, and the high cost of implementation. Moreover, many small and medium enterprises lack the technical expertise and resources required to adopt such systems, leading to limited usage in practice.

In the context of a developing economy like India, where inflation rates can fluctuate significantly, the relevance of inflation accounting becomes even more critical. Accurate financial reporting is essential not only for internal management but also for external stakeholders such as investors, creditors, and regulatory authorities.

Therefore, this study attempts to examine the concept, importance, and applicability of inflation accounting, while also analysing its practical limitations. It seeks to bridge the gap between theoretical understanding and real-world implementation by evaluating responses from professionals and business entities.

2. Objectives of the Study

1. To understand the concept and importance of inflation accounting
2. To analyse the challenges in its implementation
3. To evaluate its impact on financial statements
4. To study the role of CPI and purchasing power
5. To suggest measures for effective implementation

3. Research Methodology

The research methodology forms the backbone of the study as it provides a systematic framework for data collection, analysis, and interpretation. This study adopts a descriptive and analytical research design to examine the concept, relevance, and practical challenges of inflation accounting in the modern business environment. Both primary and secondary data sources have been utilized to ensure a comprehensive and balanced analysis.

3.1 Primary Data

Primary data has been collected to gain first-hand insights into the awareness, adoption, and challenges of inflation accounting among practitioners and business entities. A **structured questionnaire** was designed consisting of both close-ended and opinion-based questions. The questionnaire focused on aspects such as awareness levels, perceived benefits, implementation difficulties, and overall attitude toward inflation accounting practices.

The respondents included:

- **20 Accounting Professionals**, such as chartered accountants and finance executives, who possess technical knowledge of accounting practices.
- **20 Small Business Owners**, representing the segment that is most affected by inflation but often lacks access to advanced accounting systems.

A **convenience sampling method** was used for selecting respondents due to time and accessibility constraints. Although this method may limit generalization, it is suitable for exploratory studies and provides valuable indicative insights into real-world practices.

3.2 Secondary Data

Secondary data has been used to support and validate the findings obtained from primary research. It includes information collected from:

- Standard textbooks on accounting and financial management
- Peer-reviewed research journals and scholarly articles
- Government publications and economic reports, particularly those related to inflation trends and price indices

These sources helped in understanding the theoretical framework of inflation accounting, including methods such as Current Purchasing Power (CPP) and Current Cost Accounting (CCA), and their relevance in financial reporting.

3.3 Tools of Analysis

To interpret the collected data effectively, various analytical tools have been employed:

- **Percentage Analysis:** Used to present responses in a simple and understandable form, highlighting trends and patterns.
- **Comparative Analysis:** Applied to compare responses between accounting professionals and small business owners to identify differences in perception and practice.
- **Graphical Representation:** Charts and graphs are used to visually present data, making the findings clearer and more impactful.

Overall, the methodology ensures a structured approach to evaluating both theoretical concepts and practical realities of inflation accounting.

4. Results and Discussion

4.1 Awareness of Inflation Accounting

Category	Aware	Not Aware
Professionals	85%	15%
Small Businesses	40%	60%

Interpretation:

Awareness is high among professionals but significantly low among small businesses.

4.2 Major Challenges Identified

Challenge	Percentage
Complexity	30%
High Cost	25%
Lack of Standards	20%
Lack of Skills	15%
Resistance to Change	10%

Discussion:

The most significant barrier is the complexity of calculations, followed by cost-related issues.

4.3 Impact on Financial Statements

- Profit appears lower after adjustment
- Assets reflect realistic value
- Financial ratios change significantly

Analysis:

While inflation accounting improves accuracy, it may negatively impact perceived profitability, leading to management resistance.

4.4 Role of Consumer Price Index (CPI)

CPI is used to adjust financial data to reflect current purchasing power. It ensures comparability across periods but selecting the correct index remains a challenge.

4.5 Capital Maintenance

Inflation accounting helps in maintaining real capital by avoiding distribution of inflationary profits. However, incorrect implementation may still lead to capital erosion.

5. Conclusion

The study concludes that inflation accounting is important for improving the accuracy and reliability of financial reporting, especially in an inflationary economy. By adjusting financial statements for changes in purchasing power, it presents a more realistic view of a company's financial performance and position, thereby supporting better decision-making.

The findings show that methods like Current Purchasing Power (CPP) and Current Cost Accounting (CCA) help overcome the limitations of historical cost accounting. They prevent overstatement of profits and ensure that assets are valued more appropriately.

However, despite these benefits, the practical application of inflation accounting remains limited. Major challenges include technical complexity, high implementation cost, lack of standardization, and low awareness among small and medium enterprises. These issues restrict its widespread adoption.

Overall, while inflation accounting is conceptually strong and highly relevant, there is a need for simplified methods, better awareness, and supportive regulations to encourage its use in real-world business practices.

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