

(Withdrawn vide 278th Council Meeting held on May 13-15, 2008)

GN(A) 4 (Issued 1982)

Guidance Note on Accounting for Changing Prices

Foreword

Accounting, as it has come to be developed over the centuries, uses historical costs as the basis for income measurement and asset valuation. However, in the recent decades when a high rate of annual inflation has become a way of life in many countries including India, it has been felt that the historical cost information should be supplemented by adequate information reflecting the effects of inflation on an enterprise. Considerable efforts have been made by the accountants all over the world, for developing suitable methods to measure the impact of changing prices.

The Research Committee deserves our congratulations for bringing out this Guidance Note which deals with perhaps the most intricate and controversial issue in accounting since the 15th century, when Luca Pacioli – acknowledged scholar, excellent writer and an eloquent speaker – laid the foundation for the development of modern accounting through his description of double entry book-keeping. The very need for a method of accounting to take cognisance of changing prices has often been questioned; its policy implications have been widely debated; and each of the numerous methods has been vehemently discussed. The subject has interested the accounting practitioners, academicians, and users of accounting reports. While some of them have viewed it with confidence and hope, others have received it with considerable dismay and suspicion. In view of this, the guidance note is of prime significance since it represents the first pronouncement on the subject by our profession. I am sure that it will prove to be a landmark in the development of thought on the subject in our country. I earnestly urge upon the members to experiment with the methods of accounting for changing prices suggested in the guidance note so that more experience can be gained in this regard.

New Delhi
September 14, 1982

Bansi S. Mehta
President

Preface

The twentieth century in general, and the periods following the two world wars in particular, have experienced unprecedented bouts of inflation. Consequently, accountants all over the world have made determined efforts to develop suitable methods for measuring the impact of changing prices on the profitability and financial condition of an enterprise. Various methods have been developed – two of them, current purchasing power accounting (CPPA) method and current cost accounting (CCA) method have gained wide exposure. The CPPA method, while retaining the historical costs as the basis of income measurement and asset valuation, seeks to eliminate the mathematical inconsistency of conventional accounting by expressing all revenues, expenses, assets and liabilities in terms of units of uniform purchasing power. The CCA method, on the other hand, substitutes historical costs by current costs. The Research Committee of the Institute has considered the problem of accounting for changing prices in depth and has finalised this guidance note in the hope that it will encourage a wider use of methods of accounting for changing prices.

The Research Committee wishes to place on record its appreciation of the considerable efforts made by Dr. Abhijit Sen in preparing the basic draft of this guidance note. The Committee also thanks all those who contributed directly or indirectly in the preparation of this note. I hope that this guidance note will go a long way in promoting the development of the subject by stimulating thought on this subject and by encouraging its practical application at a wider level.

New Delhi
September 14, 1982

A. C. Chakrabortti
Chairman
Research Committee

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Accounting for Changing Prices

INTRODUCTION

The following is the text of the Guidance Note “Accounting for Changing Prices” issued by the Research Committee of the Institute of Chartered Accountants of India for the information and guidance of members.

1. The subject of treatment of changing prices in financial statements, popularly known as inflation accounting has assumed considerable importance in the last few decades. The persistent inflation during this period has lent urgency to the need for preparing accounting statements which reflect the effects of inflation upon an enterprise. Recognising the importance of this subject the Research Committee of the Institute of Chartered Accountants of India is bringing out this Guidance Note for the benefit of members.

2. The Research Committee wishes to acknowledge that in the preparation of this paper it has drawn heavily on the various publications on the subject by various international professional bodies and more particularly those by the Accounting Standards Committee in the U.K. The Committee recognises that a great deal of research and experimentation on the subject has already been conducted by various professional institutes, accountants and academicians and the Committee has taken these into account in framing this Guidance Note. The main objective of this Guidance Note is to encourage the adoption of accounting for changing prices, and to suggest a methodology relevant in the prevailing economic environment in India.

NEED FOR ACCOUNTING FOR CHANGING PRICES

3. The primary purpose of the financial statements of an enterprise is to present information showing from where the funds have been raised, how they have been utilised and the extent to which such utilisation has resulted in profits or losses during a period. A balance sheet shows in monetary terms the capital, the reserves, loans and other liabilities of a business as on the date at which it is prepared and how the total funds so raised have been distributed over the several types of assets. The profit and loss account on the other hand is a statement showing the way in which profits (losses) have been earned (incurred) during a period. It must be recognised that the transactions appearing in both the balance sheet and the profit and loss account are recorded in the books of account in monetary amounts which reflect their historical costs. The historical costs basis of accounting reduces to a minimum the extent to which the accounts may be

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affected by the personal judgement of those responsible for their preparation. Another advantage of historical cost-based accounts is that the transactions relating thereto are capable of being easily verified by reference to the relevant documentary and other evidence.

4. In an economic environment where prices are constantly rising, as has been the case in our country at least in the last four decades of this century, certain inherent limitations of historical cost-based accounting become apparent. Firstly, the monetary unit (rupee in our country) which is used as a standard of measurement itself shrinks in value as the prices rise. The historical cost-based accounting ignores this shrinkage in the value of a rupee as a measuring rod and keeps adding transactions which are represented by rupees of differing value over a period of time.

5. Another major problem with historical cost-based accounting is that in periods of inflation it results in substantial diminution in the operating capital and therefore in the operating capability by showing what many have termed as 'exaggerated and illusory figures' of profits*. This loss of operating capital arises due to the fact that historical cost-based accounting does not match current revenues with the current costs of operations. For example, the depreciation charge under conventional accounting is based on historical cost of fixed assets. During an inflationary period, the historical cost-based depreciation charge is not adequate to maintain the operating capability of the enterprise.

6. Another factor which contributes to the loss of operating capability is that in historical cost-based accounting, the cost of good sold charged to the profit and loss account is understated. This is because the inventories consumed are valued at their historical costs and not at their current prices. This results in over-statement of profits.

7. It is clear from the above that historical cost-based accounts do not take cognizance of the fact that in an inflationary situation the charging of the historical costs of operations to the profit and loss account may endanger the maintenance of the operating capital of an enterprise besides giving a misleading indication of its profit or loss.

8. Another drawback of the historical cost-based accounting is that by showing assets at their historical costs, the balance sheet does not reflect the current worth of the enterprise.

* In this Guidance Note, the entire discussion is with reference to inflation, which at present is almost a world-wide phenomenon. In deflation, the situation is just the reverse and the accounting may be carried on accordingly.

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METHODS OF ACCOUNTING FOR CHANGING PRICES

9. Many proposals have been offered to reduce the limitations of the conventional system of accounting and to recognise the effects of changing prices on the financial statements. Though no consensus has yet been reached on a specific solution, the professional bodies in various countries have issued a number of statements suggesting the use of different methods of accounting for changing prices. Noteworthy among them are FAS 33 (FASB, USA), SSAP 16 (ASC, U.K.) and IAS 15 (International Accounting Standards Committee). It would indeed be a major development in the building up of a coherent and logical structure of accounting if an objective and useful method of accounting for changing prices gains universal acceptance.

10. Out of the many proposals that have been put forward for accounting for changing prices the following three need specific consideration:

- (i) Periodical revaluation of fixed assets along with the adoption of LIFO formula for inventory valuation.
- (ii) The current purchasing power accounting method (CPPA)
- (iii) The current cost accounting method (CCA)

Each of these methods is discussed in the subsequent paragraphs.

Periodical Revaluation of Fixed Assets along with the Adoption of LIFO

11. Many enterprises have in periods of inflation been able to keep their operating capability more or less intact by revaluing their fixed assets periodically and by simultaneously adopting the LIFO formula for stock valuation. The main objective of periodic revaluation of fixed assets is to charge by way of depreciation to the Profit and Loss Account an amount which reflects the current cost of replacement. Under this method, the enterprises estimate the replacement cost of the fixed assets at regular intervals of say 3 to 5 years and charge depreciation on the revalued amounts. The revaluation of assets is normally based on expert opinion or on certain specific price indices indicative of the replacement cost of the relevant fixed assets.

12. Many enterprises adopt LIFO (last in-first out) formula for assigning costs between the cost of goods sold and the closing stocks. In many countries like the USA, LIFO has been accepted as a valid basis for assigning costs for

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the purposes of taxation. Under this method the latest purchase costs are assigned to the cost of goods sold and are therefore written off. The closing stocks on other hand are valued at the earlier costs.

13. Adoption of periodical revaluation along with LIFO is one of the practical approaches to the problem of maintenance of operating capability in a period of inflation. It seeks to maintain the operating capability of an enterprise at least with regard to the fixed assets and the inventories – undoubtedly the two most significant components of the operating capital of an undertaking. However, it must be mentioned that this approach is not a complete solution to the problem. Periodic revaluations tend to be somewhat adhoc in nature and lack the advantages incidental to a systematic and consistent basis. Moreover with the high inflation rates in the present day economies even regular revaluations, say every five years, may not serve the purpose of maintaining the operating capability of an enterprise. Similarly LIFO may in some situations result in the cost of goods sold being reflected at current costs but in many other situations the cost assigned on the basis of LIFO may still fall substantially short of the amount which should be charged as the current cost of goods sold to maintain the operating capability of the enterprise as far as the inventories are concerned. In view of this, the approach has significance only till such time that a comprehensive and widely acceptable method of accounting for price changes is adopted.

Current Purchasing Power Accounting (CPPA)

14. This method seeks to restate the financial statements in terms of units of equal purchasing power and thus eliminates the effects of changes in the value of money itself. It has been stated earlier that money as a measuring rod is somewhat defective since its value (its command over goods and services in general) keeps on changing due to inflation or deflation. The current purchasing power accounting method overcomes this limitation of the conventional financial statement by restating them in terms of uniform rupees of current purchasing power. Thus the method is not strictly a proposal for a change from the historical cost-based accounting; it merely attempts to remove the distortions in the financial statements which arise due to changing value of rupee.

15. To convert the historical rupees into uniform rupees as at the date of the balance sheet an index portraying the changes in the general purchasing power of the rupee is required. Generally therefore the most broad based index of consumer goods prices or of prices in general is used. The historical cost figures are multiplied by a conversion factor which is the ratio of the index at the date of conversion and the index at the transaction date. Assume that an

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item of furniture was purchased on January 1, 1978 for Rs. 20,000/-. Its value in terms of rupees of current purchasing power as on December 31, 1980 can be ascertained by multiplying its historical cost by the index number as on December 31, 1980 and dividing the product by the index number as on January 1, 1978. If the general price index on the two dates was 243 and 189 respectively, the cost of the furniture in terms of rupees of December 31, 1980 would be Rs. 25,714 (i.e. Rs. 20,000 x 243/ 189).

Since it is practically very difficult to convert each figure in terms of the index number of the date of the transaction, it is assumed that all transactions take place evenly throughout the year.

16. In converting the historical rupees into rupees of uniform value as at the date of the balance sheet the current purchasing power accounting method makes a distinction between the monetary items and the non-monetary items. Monetary items are those the amounts of which are fixed by contract or otherwise remain fixed irrespective of any change in the general level of prices. Examples of monetary assets are cash, debtors, bills receivable, etc. Similarly, debentures, creditors, etc. are monetary liabilities. It is obvious that in a period of inflation, the holders of monetary liabilities gain since they repay the amounts due in rupees of lower purchasing power as compared to that at the time when the liabilities arose. Conversely, the holders of net monetary assets lose in a period of inflation. The current purchasing power accounting method therefore suggests the computation of the purchasing power gain or loss made by an enterprise on holding net monetary items.

17. A number of adjustments are required to be made to restate the conventional financial statements on the basis of current purchasing power. The illustration at Appendix I shows the basic methodology adopted for the purpose of such restatement.

18. The main advantage of the current purchasing power accounting method, as already stated, is that it removes the shortcomings of money as a measuring rod during the period of price changes. As it uses uniform purchasing power as the measuring unit, it possesses the qualities of objectivity and comparability. Besides, it retains the historical cost accounts as the basic accounts and the price-level adjusted accounts are shown only on a supplementary basis. It is simple to apply and is not very expensive. However, the current purchasing power accounting method has lost considerable support in the recent years mainly because of the fact that the unit of measurement proposed by the method (general purchasing power) is not easily perceived by the users of financial statements. Everyone understands and perceives the

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monetary unit, but only very few understand a purchasing power unit. Besides, unlike a monetary unit, the purchasing power unit is not a physical object capable of being exchanged between parties to a transaction. Moreover, the method does not solve, except indirectly and incidentally, the problem of gradual depletion of operating capital of an enterprise in periods of inflation. The balance sheet too, prepared on the CPPA basis, does not reflect the current worth of an enterprise.

Current Cost Accounting (CCA)

19. Current cost accounting or CCA, as it is popularly known, seeks to:
- (a) state the assets and liabilities in the balance sheets at their current value, i.e., value as at the date of the balance sheet;
 - (b) measure the profit or loss after matching current costs with current revenues; and incidentally
 - (c) remove the distortions of summing up of rupees of different values.
20. CCA is based on the concept of “operating capability” which may be viewed as the amount of goods and services which an entity is capable of providing with its existing resources during a given period. It is argued that in order to maintain its operating capability, an entity should continuously remain in command of resources which form the basis of its activities. To this end, it is necessary to take into account the rising costs of assets consumed in generating the revenues. Current cost accounting by substituting the current cost of assets consumed in place of the corresponding historical costs, takes into account the changes in specific prices of assets as they affect the entity.
21. This method was originally proposed by the Sandilands Committee as Current Cost Accounting (CCA). After considerable debate, in 1980 the Accounting Standards Committee in the U.K. issued the Standard on the subject, i.e., SSAP 16.

The main features of the method are:

- (i) Money is the unit of measurement.
- (ii) Assets and liabilities are shown in the balance sheet at a valuation (discussed later in detail).

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- (iii) Operating profit is struck after charging the “value to the business” of assets consumed during the period. Three adjustments – depreciation, cost of sales and monetary working capital – are made to the historical cost profit to arrive at the current cost profit. A fourth adjustment known as gearing adjustment is made to arrive at the current cost profit attributable to the shareholders (discussed later in detail).

Methodology of CCA

22. *Fixed Assets* : The fixed assets should be shown in the balance sheet at their “value to the business”. The value to the business of an asset is the amount which the business would lose if it were deprived of that asset. The concepts of gross and net current replacement cost are important in this context. The gross current replacement cost of an existing asset is the cost that would have to be incurred at the date of the valuation to obtain and install a substantially identical asset in new condition. For example, if an equipment purchased on 1.1.1978 for Rs. 80,000 can be purchased on 31.12.1980 for Rs. 1,00,000 its gross current replacement cost on 31.12.1980 is Rs. 1,00,000. The net current replacement cost of an existing asset refers to that part of the gross current replacement cost which represents its unexpired service potential. For example, suppose that the equipment in the above example is estimated to have an economic life of five years. Since it has already been used for three years, its net current replacement cost would be Rs. 40,000 (assuming that the equipment will have a zero scrap value at the end of its economic life).

23. *Plant and Machinery*: The gross current replacement costs of items of plant and machinery and other fixed assets (except land and buildings) may be determined by applying the relevant indices to their gross book values. In U.K., the government statistical department regularly publishes indices for various categories of fixed assets and for different industries. In India, however, there is no such agency which publishes specific indices for fixed assets employed in various industries. However, the Bulletin of Wholesale Prices published every month by the Government of India contains details about the price changes of a number of capital assets. In case the use of specific indices is considered inappropriate or impracticable the gross current replacement cost may be determined on the basis of the expert opinion or by comparison with other assets or groups of assets having a similar service potential for which information may be available.

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24. *Land and Buildings*: The land & buildings occupied by the owner himself should be shown in the balance sheet at their “value to the business” which will normally be the open market value for their existing use, plus estimated acquisition costs. However, in cases where an open market valuation of the land and buildings as whole cannot be made, the net replacement cost of the buildings and the open market value of land for its existing use plus the estimated acquisition costs should be taken as their value to the business. The valuation should be made by professionally qualified valuers at periodic intervals.

25. *Inventories*: In the balance sheet the inventories should normally be shown at the lower of the current replacement cost as on the date of the balance sheet and the net realisable value.

26. *Current Cost Operating Profit*: The current cost operating profit should be ascertained by making the following three adjustments to the historical cost profit (before interest on net borrowings). Those adjustments represent the allowance for the impact of price changes on the funds required for maintaining the net operating assets.

- (a) depreciation adjustment
- (b) cost of sales adjustment
- (c) monetary working capital adjustment

27. *Depreciation Adjustment*: The charge to the profit and loss account for depreciation should be equal to the value to the business of the fixed assets consumed during the period. When the fixed assets are valued on the basis of their net current replacement cost, which may increase during the year, the charge may be based on the average net current replacement cost for the period. The current depreciation charge is obtained by apportioning the average net current replacement cost over the expected remaining useful life of the fixed assets as at the beginning of the period. When the fixed assets are revalued every year, there will also be a shortfall of depreciation representing the effect of price rise during the current year on the accumulated depreciation till date. This shortfall is called backlog depreciation which is the amount needed to uplift the accumulated depreciation to a figure needed to cover the total depreciation provision based on replacement cost at the year-end. This backlog depreciation arising out of increase in current costs could be charged either to the general reserves or against the related revaluation surplus on the fixed assets. The former will ensure that the enterprise maintains its operating capital at the time of the replacement of fixed assets. The latter is the recommended procedure in the U.K. standard on the subject.

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28. *Cost of Sales Adjustment:* The second adjustment is known as 'cost of sales adjustments' (COSA). This represents difference between the value to the business of the stock consumed during the period and its historical cost. The value to the business of stock will generally be its replacement cost at the date of consumption. Theoretically, the current cost of sales should be determined on an item-by-item basis. In a real world situation, however, it would be impragmatic to do so, and therefore, groups of similar items may be used instead. If a company has a fairly regular sales pattern and if prices have increased steadily during the period, the use of the average method of calculation of current cost of sales may be appropriate.

29. *Monetary Working Capital Adjustment:* The third adjustment called the 'monetary working capital adjustment' (MWCA) reflects the amount of additional (or reduced) finance needed for monetary working capital as a result of changes in the input prices of goods and services used and financed by the business. Monetary working capital (usually represented by the difference between the trade debtors and trade creditors) is an integral part of the net operating assets of the business. In times of rising prices, a business needs more funds to finance monetary working capital. The adjustment reflects this additional need for funds.

30. *Gearing Adjustment:* It is argued that the profit as calculated above reflects the true amount of profit from operation (current cost operating profit) after maintaining the net operating capability of the entity. However, to the extent that the net operating assets are funded through borrowings, the impact of price changes made in arriving at current cost operation profit is not on the shareholders. This is because the repayment obligations in respect of borrowings are not affected by changing prices. It is therefore suggested that the current cost profit attributable to shareholders should be determined by taking into account the method of financing the net operating assets. The current cost profit attributable to shareholders reflects the surplus for the period after making allowance for the impact of price changes on the funds needed to maintain the shareholders' proportion of the net operating assets. To take note of the existence of borrowings in the capital structure, an adjustment known as 'gearing adjustment' is made.

31. A new reserve, the 'current cost reserve', is created to take the credits or charges relating to the revaluation of fixed assets and stock, as also those relating to the depreciation adjustment, the cost of sales adjustment, the monetary working capital adjustment, and the gearing adjustment.

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32. *Price Indices in CCA:* Accounting for changing prices involves the use of certain price indices for the restatement of assets and for making adjustments to the historical cost profit and loss account. In the United Kingdom, the Government Statistical Service regularly publishes the relevant price indices. In India, database at such a large scale has not yet been developed. However, the Bulletin of wholesale prices published every month by the Government of India contains details about the price changes of a number of items.

33. The CCA method possesses the merit of closely approximating the impact of specific price changes on the business enterprise because it makes use of specific indices. As such, the method seeks to maintain the operating capability of the enterprise during inflation. The method is however, not free from weaknesses, the most important of which seems to be the element of subjectivity inherent in periodic valuations, specially in our country where specific indices are not generated by an authoritative external agency.

34. From the discussion above, it is clear that during a period of rising price, historical cost-based financial statements show inflated profits and that the taxation of such profits amounts to a levy on capital. Thus, there is a need for reform in our tax laws and practices which should take into account the impact of rising prices on the funds required for maintenance of the operating capability.

35. Appendix II shows an illustrative set of current cost accounts as adapted from the guidance notes issued by the Accounting Standards Committee in the U.K.

RECOMMENDATIONS

36. The rationale for an accounting technique to make necessary adjustments for changing prices, as also the main solutions, have been discussed above. The Committee's recommendations in this regard are contained in paragraphs 37 - 43.

37. The adoption of a system of accounting for changing prices would require a considerable amount of time, money and specialised skills. Also the various techniques are still in the process of development. However, in view of the importance of the subject, it is recommended that enterprises, particularly the large enterprises, may develop the necessary systems to prepare and present this information.

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38. Out of the various methods of accounting for changing prices discussed above, the Current Cost Accounting method seems to be most appropriate in the context of the economic environment in India. The periodic revaluations of fixed assets and the adoption of LIFO formula for inventory valuation are partial responses to the problem of accounting for changing prices. Current Purchasing Power Accounting, though simple to apply, does not ensure the maintenance of the operating capability of an enterprise. Current Cost Accounting, on the other hand, is a rational and comprehensive system of accounting for changing prices as it considers the specific effect of changing prices on individual enterprises and thus ensures that profits are reported only after maintaining the operating capability. However, the introduction of a full-fledged system of Current Cost Accounting on a wide scale in India will inevitably take some time. During this transitional phase, periodic revaluations of fixed assets along with the adoption of LIFO formula for inventory valuation would reflect the impact of changing prices substantially in the case of manufacturing and trading enterprises.

39. Adequate data base has presently not been developed in India for accounting for changing prices. Therefore, every enterprise may have to select the price indices depending on its own circumstances. The detailed price indices published in its monthly bulletin by the Government of India can be adopted in a number of cases. There is no doubt that further steps will have to be taken for the timely publication of statistical information required by various industries for the implementation of accounting for changing prices.

40. Considering the importance of the information regarding the impact of changing prices it is recommended that while the primary financial statements should continue to be prepared and presented on the historical cost basis, supplementary information reflecting the effect of changing prices may also be provided in the financial statements on a voluntary basis, at least by large enterprises.

41. Since the presentation of statements adjusted for the impact of changing prices is voluntary, the enterprise may or may not get this information audited. However, the audit of such statements would enhance their credibility.

42. Apart from its utility in external reporting, accounting for changing prices may also provide useful information for internal management purposes. Accounting information system is designed primarily to provide relevant information to various levels of management with a view to assist in managerial decision making, control and evaluation. However, in periods of rapid and violent fluctuations in prices, the information provided by historical cost-based accounting system may need to be supplemented by information regarding the

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impact of changing prices. The areas in which such information may be of prime importance to management include investment decisions and allocation of resources, divisional and overall corporate performance evaluation, pricing policy, dividend policy etc.

43. In countries like the United Kingdom, there have been some reforms in the tax structure in the wake of introduction of accounting for changing prices. Though, the tax legislation in India at present does not give recognition to such an accounting system, even then accounting for changing prices would be useful for generating relevant information for internal and external decision making.

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Appendix I

*Example of the presentation of a
Supplementary Current Purchasing Power Statement**

**Summary of Results and Financial Position Adjusted
for the Effects of Inflation**

Results for the Year

	Historical Basis	Current Purchasing Power Basis
	Rs./lakhs	Rs./lakhs
Sales	3,542	4,074
Profit before taxation (See note 2)	405	378
Taxation (See note 3)	283	283
Profit/Loss after taxation	122	95

Financial Position at the end of the Year

	Rs./lakhs	Rs./lakhs
<i>Capital and Loan Funds</i>		
Shareholders' Funds	773	1,175
Loan Funds	177	177
	950	1,352
<i>Application of Capital & Loan Funds</i>		
Fixed Assets	438	818
Investment	26	28
Net Current Assets	486	506
	950	1,352

Ratio

Earnings per share (Rs.) (based on 80,00,000 equity shares in issue)	1.525	1.1875
Return on total equity interest (%)	15.8	8.1
Net assets per share (Rs.)	9.7	14.7

* The methodology is the same as suggested in the Provisional Statement of Standard Accounting Practice No. 7, "Accounting for changes in the purchasing power of money" issued by the Institute of Chartered Accountants in England and Wales.

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Note

(1) The figures in the current purchasing power basis columns were arrived at by converting the corresponding figures in the historical basis columns by reference to the changes in a general price index between the dates of the original transactions and the end of this year. The current purchasing power basis figures are measured in rupees of purchasing power at the end of this year. The general price index used for this purpose is the wholesale price index (Source: Indian Labour Journal published by the Government of India) which stood at 313.1 at the beginning of the year and at 410.5 at the end of year (Base: April 1952 - March 1953 = 100).

(2) The difference between the profit on a historical basis and the profit on a current purchasing power basis is explained below :

	Rs./lakhs
Profit before Taxation	
(Historical basis)	405
Adjustment to convert to current purchasing power basis:	
Stock	
Additional charge based on restating the cost of stock at the beginning and end of the year in rupees of current purchasing power, thus taking the inflationary element out of the profit on the sale of stock	(210)
Depreciation	
Additional depreciation based on cost, measured in rupees of current purchasing power, of fixed assets	(50)
Monetary Items	
Net gain in purchasing power resulting from the effects of inflation on the company's net monetary liabilities	145
Sales, Purchases and all other costs	
These are increased by the change in the index between the average date at which they occurred and the end of the year. This adjustment increases profit as sales exceed the cost included in this heading	88 (27)
<i>Profit before taxation (current purchasing power basis at the end of the year under review)</i>	<u>378</u>

(3) Taxation liabilities are calculated with reference to profits on historical cost basis and no adjustment is therefore made to the tax charge on the CPP basis.

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Appendix II

This appendix illustrates how a set of current cost accounts can be prepared from historical cost accounts.*

The profit and loss account and the balance sheet of Z Ltd for the year 1979 are as below:

Z Limited
Historical cost (HC) profit and loss account for the
year ended 31st December 1979

	1979
	<u>Rs. '000</u>
Turnover	<u>64,000</u>
Trading profit (including HC profit on fixed asset disposal -- Rs. 1,000,000)	5,200
Less : net interest payable	1,000
	<u>4,200</u>
Taxation	<u>700</u>
Profit attributable to shareholders	3,500
Proposed dividends	300
Retained profit of the year	<u>3,200</u>
Statement of retained profits/revenue reserves	
Retained profit of the year	3,200
Revenue reserves at the beginning of the year	5,502
Revenue reserves at the end of the year	<u>8,702</u>

* Adapted from Guidance Notes on SSAP 16, "Current Cost Accounting". The amounts, however, have been stated in terms of rupees.

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Z Limited
Historical cost balance sheet
at 31st December 1979

1978			1979	
Rs.'000	Rs.'000		Rs.'000	Rs.'000
	11,502	Fixed assets		12,202
		Current assets:		
2,000		Cash	3,000	
6,000		Stock	8,000	
9,000		Trade debtors	10,500	
<u>17,000</u>			<u>21,500</u>	
		Current liabilities:		
5,000		Trade creditors	6,000	
1,000		HP creditors	700	
3,000		Overdraft	2,300	
750		Taxation	700	
250		Proposed dividend	300	
<u>10,000</u>			<u>10,000</u>	
	7,000	Net current assets		11,500
	<u>18,502</u>			<u>23,702</u>
	6,000	Share Capital		7,000
		Reserves:		
	—	Share premium		1,000
	5,502	Revenue		8,702
	<u>11,502</u>	Shareholders' capital and reserves		16,702
	6,000	Convertible debentures		6,000
	<u>1,000</u>	Deferred tax		1,000
	<u>18,502</u>			<u>23,702</u>

The procedure involved in converting historical cost accounts into current cost accounts is set out in the following sections:

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SECTION A : COMPUTATION OF (i) CURRENT COST OF FIXED ASSETS, AND (ii) CURRENT COST DEPRECIATION CHARGE

Historical Cost

Plant and Machinery

A.1. Plant and machinery has in the past been depreciated on a straight line basis over 14 years. Upon the introduction of CCA it is necessary to review the assets lives used for depreciation purposes. As a result of this review it was decided that life of 14 years was appropriate and thus should be adopted for CCA purposes. On 1st January 1979, the plant and machinery in the historical cost records included the following:

Year of Purchase	Historical cost Rs. '000	Accumulated depreciation Rs. '000
1966	600	557
1967	400	343
1968	400	314
1969	800	571
1970	—	—
1971	—	—
1972	800	400
1973	2,100	900
1974	700	250
1975	1,000	285
1976	400	86
1977	4,100	585
1978	2,900	207
Total assets being depreciated	14,200	4,498

A.2. The HC depreciation charge for the year is based on cost as follows:

	Rs. '000
Gross HC* of assets at 1 st January 1979, still being depreciated	14,200
Disposals*	(1,600)
Additions	1,700
	<u>14,300</u>
The year's charge (one-fourteenth) (say)	1,000

* Proper records of disposals have been kept and thus all assets with a cost attributable to them exist and are still in use. In practice it is necessary to relate disposals and accumulated depreciation to the year of acquisition. For the purpose of this example the gross current cost (GCC) of these disposals at 1st January 1979 is Rs. 3,000,000 with related accumulated depreciation of Rs. 1,100,000.

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A.3. Summary of HC movements in fixed assets:

	Freehold land	Plant and machinery	Depreciation		Total
	Historical cost	Historical cost	Rs. '000	Rs. '000	Rs. '000
At 1st January 1979	1,800	14,200	(4,498)	9,702	11,502
Disposals	--	(1,600)	600	(1,000)	(1,000)
Additions	1,000	1,700	--	1,700	2,700
Depreciation	--	--	(1,000)	(1,000)	(1,000)
At 31st December 1979	2,800	14,300	(4,898)	9,402	12,202

Current Cost

Plant and Machinery

A.4. On 1 January 1979, the current cost and accumulated depreciation of the plant and machinery comprised:

Year of purchase	Index No. (Mid year)	Gross current cost at 1st January, 1979	Accumulated depreciation
		Rs.'000	Rs.'000
1966	41.7	2,050 *	1,900
1967	43.3	1,310	1,120
1968	43.6	1,310	1,030
1969	45.5	2,500	1,780
1970	46.8	--	--
1971	51.5	--	--
1972	57.4	1,990	990
1973	61.4	4,870	2,090
1974	65.5	1,520	540
1975	77.4	1,840	530
1976	100.0	570	120
1977	113.8	5,130	730
1978	133.7	3,090	220
		26,180	11,050

* See Note A.5.

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A.5. Index at 31st December 1978	142.5
Index at 30th June 1979	149.2
Index at 31st December 1979	154.6

Example of calculation of GCC at 1st January 1979 of asset bought in 1966:

$$600 \text{ (HC)} \times \left(\frac{142.5}{41.7} \right) = 2,050$$

A.6. For simplicity, it is assumed that all plant and machinery is covered by one index and has one life measurement for depreciation purposes. In practice, a number of indices and lives may be applicable. If the information to arrange costs in this way is not available then the indexation route to the ascertainment of current cost may not be available.

A.7. The depreciation charge for the year is based on average current cost, as follows:

	Rs.'000
All assets at gross current cost on 1st January 1979 (A.4)	26,180
Less disposals at gross current cost on 1st January 1979 (A.2 footnote)	3,000
	<hr/>
	23,180
Adjusted to the average current cost for year	
$\left(\text{Rs. } 23,180,000 \times \frac{149.2}{142.5} \right)$	24,270
Additions during the year (which are assumed to be at average cost) (A.3)	1,700
	<hr/>
	25,970

The year's current cost depreciation charge of one fourteenth of Rs. 25,970,000 is Rs. 1,855,000 (say)	1,850
Less depreciation already charged in the HC accounts (A.2)	1,000
	<hr/>
Depreciation adjustment	850

Total depreciation charged in the CC profit and loss account represents the average current cost of the proportion of fixed assets consumed in the period. The depreciation adjustment of Rs. 850,000 is the difference between the depreciation charge in the HC and CC accounts.

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Current Cost Reserve

A.8. The transfer to current cost reserve, in respect of price changes during the year on fixed assets, is arrived at as follows:

	Current cost	Accumulated depreciation
	Rs. '000	Rs. '000
Plant and machinery		
At 1st January 1979 (A.4)	26,180	11,050
Disposals (A.2)	<u>3,000</u>	<u>(1,100)</u>
Call this sum-A	<u>23,180</u>	<u>9,950</u>
Effect of price change thereon during year based on		
$\left(\frac{154.6 - 142.5}{142.5} \right) \times A$	1,968	845
Additions and depreciation charge in year - call this B	1,700	1,850
Effect of price change from mid to end of year		
$\left(\frac{154.6 - 149.2}{149.2} \right) \times B$	<u>62</u>	<u>67</u>
Transfer to CCR -- gross and 'backlog' (net Rs. 1,118,000)	<u>2,030</u>	<u>912</u>
Total at 31st December 1979	26,910	12,712
Freehold land		
The directors' revaluation gave an uplift of	<u>300</u>	<u>--</u>

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A.9. Summary of CC movements in fixed assets

	Freehold land		Plant and machinery		Total
	Current cost	Current cost	Depreciation	Net	
	Rs.'000	Rs.'000	Rs.'000	Rs.'000	Rs.'000
At 1 st January 1979	3,310	26,180	(11,050)	15,130	18,440
Disposals (A.2)	-	(3,000)	1,100	(1,900)	(1,900)
Additions	1,000	1,700	-	1,700	2,700
Depreciation	-	-	(1,850)	(1,850)	(1,850)
Transfer to CCR (A.8/Section D)	<u>300</u>	<u>2,030</u>	<u>(912)</u>	<u>1,118</u>	<u>1,418</u>
At 31 st December 1979	<u>4,610</u>	<u>26,910</u>	<u>(12,712)</u>	<u>14,198</u>	<u>18,808</u>

A.10. Reconciliation of unrealised revaluation surpluses (URS) on fixed assets:

	HC		CC		URS	
	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000	Rs. '000
Freehold land						
1 st January 1979	1,800		3,310			1,510
Additions	1,000		1,000		--	
Uplift	<u>--</u>		<u>300</u>		<u>300</u>	<u>300</u>
31 st December 1979	<u>2,800</u>		<u>4,610</u>			<u>1,810</u>
Plant and machinery						
1 st January 1979 (NBV)	9,702		15,130			5,428
Disposals (NBV) (A.11)	(1,000)		(1,900)		(900)	
Additions	1,700		1,700		--	
Uplift (A.8):						
gross	--	2,030				
backlog depreciation	--	(912)	1,118	1,118		
Depreciation charge	<u>(1,000)</u>	<u>--</u>	<u>(1,850)</u>	<u>(850)</u>		<u>(632)</u>
31 st December 1979 (NBV)	<u>9,402</u>		<u>14,198</u>			<u>4,796</u>

(Note : There are no unrealised revaluation surpluses in the HC accounts).

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Fixed asset disposals

A.11. Proceeds on disposal of fixed assets were Rs. 2,000,000. This gives rise to the following calculations of surplus on disposal:

	HC Rs. '000	CC Rs. '000	Difference Rs. '000
Proceeds	2,000	2,000	--
NBV of assets disposal -			
HC (A.3)	1,000		
CC (A.9)		1,900	900
Surplus on disposal –P&L	<u>1,000</u>	<u>100</u>	
Current cost operating adjustment on FA disposal— dr. P & L			
cr. Asset account			<u>900</u>

The adjustment of Rs. 900,000 on the disposal of fixed assets represents the difference between the historical and current cost net values of the assets in question at the date of disposal.

**SECTION B : COMPUTATION OF (i) CURRENT COST OF STOCK,
AND (ii) COST OF SALES AND MONETARY WORKING CAPITAL
ADJUSTMENTS**

In order to allow for the impact of price changes on working capital, two adjustments are made to the operating costs calculated on the historical cost basis, one on stock and the other on monetary working capital. The adjustments are based on movements in price indices. These indices reflect closely the changes in input prices experienced by the company.

B.1. It is assumed in the example that the change in stock levels occurred fairly evenly during the period and that the historical cost of the stock has been calculated on a 'first in first out' basis.

Appropriate index numbers for the COSA and MWCA are selected from the following table:

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1978	October	173.3	
	November	175.4	————— (a)
			————— (b)
	December	177.4	
			————— (c)
1979	January	179.6	
	February	181.0	
	March	183.3	
	April	185.8	
	May	187.7	
	June	189.9	
	July	191.9	
	August	193.6	
	September	195.6	
	October	197.9	————— (d)
	November	200.1	
			————— (e)
	December	202.4	
			————— (f)
1980	January	204.4	

Note : Each index is applicable at the middle of the month concerned.

Index numbers used in this example

(a)	Mid November 1978	175.4
(b)	30 November 1978 –(average of Nov/Dec)	176.4
(c)	31 December 1978 –(average of Dec/Jan)	178.5
(d)	Mid October 1979	197.9
(e)	30 November 1979 –(average of Nov/Dec)	201.3
(f)	31 December 1979 –(average of Dec/Jan)	203.4
(g)	Simple monthly average based on 12 months to 31 st December 1979	190.7

B.2. Calculation 1 – The cost of sales adjustment (COSA)

In this example the opening stock represents three months' purchases and the closing stock represents five months' purchases.

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COSA

Using the average method, the COSA is calculated as follows:

(i) Ascertain relevant index numbers:

- (a) Opening stock (mid November 1978) 175.4
- (d) Closing Stock (mid October 1979) 197.9
- (g) Average for the year to 31 December 1979 190.7

(ii) From the historical cost of the closing stock deduct the historical cost of the opening stock:

$$\text{Rs. } 8,000,000 - \text{Rs. } 6,000,000 = \text{Rs. } 2,000,000$$

(iii) Isolate the effect of the volume change. From the average current cost of the closing stock deduct the average current cost of the opening stock:

$$\begin{aligned} & \left(\frac{\text{HC closing stock}}{\text{Closing index number}} \right) \times \text{Average index number} \\ \text{minus } & \left(\frac{\text{HC opening stock}}{\text{Opening index number}} \right) \times \text{Average index number} \\ = & \left(\frac{\text{Rs. } 8,000,000}{197.9} \times 190.7 \right) - \left(\frac{\text{Rs. } 6,000,000}{175.4} \times 190.7 \right) \\ = & \text{Rs. } 1,185,570 \end{aligned}$$

(iv) From the result in (ii) (the total increase) deduct the result in (iii) (the 'volume' increase) to give COSA (the 'price' increase):

$$\text{Rs. } 2,000,000 - \text{Rs. } 1,185,570 = \text{Rs. } 814,430 \text{ (say) } \quad \underline{\text{Rs. } 810,000}$$

The above method is represented by the following formula:

$$\text{COSA} = (C - O) - Ia \left(\frac{C}{Ic} - \frac{O}{Io} \right)$$

- Where
- O = Historical cost of opening stock
 - C = Historical cost of closing stock
 - Ia = Average index number for the period
 - Io = Index number appropriate to opening stock
 - Ic = Index number appropriate to closing stock

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B.3. *Balance sheet value of stock at current cost*

Stock should be stated in the balance sheet at value to the business. In order to ascertain its current cost, a separate calculation from the COSA must be made.

(i) Ascertain relevant index numbers:	
(c) At 31 December 1978	178.5
(f) At 31 December 1979	203.4
(ii) Calculate current cost:	Rs. '000
Opening stock (as at 31 Dec. 1978)	
$6,000 \times \frac{178.5}{175.4} = 6,100$	
<i>Unrealised revaluation surplus</i>	
(6,100 – 6,000)	100
Closing Stock (as at 31 st Dec. 1979)	
$8,000 \times \frac{203.4}{197.9} = 8,220$	
<i>Unrealised revaluation surplus</i>	
(8,220 – 8,000)	220
<i>Increase in unrealised revaluation surplus</i>	<u>+ 120</u>

The increase in unrealised revaluation surpluses (Rs. 120,000) is reflected in the current cost reserve together with the COSA (Rs. 810,000).

B.4. *Calculation 2 – The monetary working capital adjustment (MWCA)*

As the COSA is calculated using the averaging method, the MWCA should be calculated on a similar basis. The MWCA represents that part of the change in the amount of the MWC resulting from changes in price and excludes changes arising from volume.

In this example it is assumed that MWC consists only of trade debtors and trade creditors. At both dates debtors exceed creditors. It is also assumed that the average age of the opening and closing MWC is one month.

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		Rs.'000
The opening MWC is	(9,000 – 5,000)	4,000
The closing MWC is	(10,500 – 6,000)	4,500

The same index is used as for the COSA and the index numbers for the opening and closing MWC reflect the average age of debtors and creditors. The MWCA is calculated as follows:

- (i) Ascertain relevant index numbers:
 - (b) Opening MWC (30 Nov. 1978) 176.4
 - (e) Closing MWC (30 Nov. 1979) 201.3
 - (g) Average for year to 31 Dec. 1979 190.7

- (ii) From the balance sheet value of the closing MWC deduct the balance sheet value of the opening MWC:

$$\text{Rs. } 4,500,000 - \text{Rs. } 4,000,000 = \text{Rs. } 500,000$$

- (iii) Isolate the effect of the volume change. From the value of the closing MWC deduct the value of the opening MWC (adjusting both values to the average price for the period) :

$$\begin{aligned} & \left(\frac{\text{Balance sheet value of closing MWC}}{\text{Closing index number}} \right) \times \text{Average index number} \\ \text{minus} & \left(\frac{\text{Balance sheet value of opening MWC}}{\text{Opening index number}} \right) \times \text{Average index number} \\ & = \left(\frac{\text{Rs. } 4,500,000}{201.3} \times 190.7 \right) - \left(\frac{\text{Rs. } 4,000,000}{176.4} \times 190.7 \right) \\ & = (-)\text{Rs. } 61,220 \end{aligned}$$

- (iv) From the result in (ii) (the total increase) deduct the result in (iii) (the 'volume' increase) to give the MWCA (the 'price' increase):

$$\text{Rs. } 500,000 - (-\text{Rs. } 61,220) = \text{Rs. } 561,220 \text{ (say) Rs. } 560,000$$

In this case debtors exceed creditors and thus the adjustment is a charge against profits. Where creditors exceed debtors and prices are rising the adjustment will be a credit to profit.

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- (v) The above method (which is identical to that used for the COSA) is represented by the following formula :

$$MWCA = (C - O) - Ia \left(\frac{C}{Ic} - \frac{O}{Io} \right)$$

Where O = Opening MWC
C = Closing MWC
Ia = Average index number for the period
Io = Index number appropriate to opening MWC
Ic = Index number appropriate to closing MWC

SECTION C : COMPUTATION OF GEARING ADJUSTMENT

A proportion, called the gearing proportion, of the net operating assets of the business is financed by borrowing. As the obligation to repay borrowing is fixed in monetary amount, irrespective of price changes on the proportion of assets so financed, it is unnecessary to provide for the impact of price changes on these assets when determining the current cost profit attributable to shareholders. Thus, the gearing adjustment has been applied which abates the current cost operating adjustments by the average gearing proportion in the year. The gearing adjustment is computed as below:

	Opening Rs. '000	Closing Rs. '000
The net borrowing is as follows:		
Convertible debentures and deferred taxation	7,000	7,000
HP creditors	1,000	700
Bank overdraft	3,000	2,300
Taxation	750	700
Cash	<u>(2000)</u>	<u>(3000)</u>
Total net borrowings – the average of which equals L	<u>9,750</u>	<u>7,700</u>
Share capital plus reserves from the current cost balance sheet	18,540	23,528
Proposed dividends	<u>250</u>	<u>300</u>
Total shareholders' interest – the average of which equals S	<u>18,790</u>	<u>23,828</u>
Total – the average of which equals L+S	<u>28,540</u>	<u>31,528</u>

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The average gearing proportion is $\frac{L}{L + S}$

$$\frac{L}{L + S} \text{ equals } \frac{9,750 + 7,700}{28,540 + 31,528} = 29.1\%$$

The gearing adjustment is calculated by applying this percentage to the full adjustments made to allow for the impact of price changes as the net operating assets are used or sold.

Current cost adjustments.	Rs. '000	
Depreciation	(A.7) 850	
Fixed asset disposal	(A.11) 900	
COSA	(B.2) 810	
MWCA	(B.4) 560	
	<u>3,120</u>	$\times 29.1\% = 907,920$
		(say) <u>Rs. 910,000</u>

SECTION D : CURRENT COST RESERVE

Reference to workings	1 Jan. 1979	Revaluation adjustments during year	Profit and loss account	31 Dec. 1979
	Rs. '000	Rs. '000	Rs. '000	Rs. '000
Unrealised revaluation surpluses arising on :				
A.8/A.10 Land	1,510 ²	300		1,810 ²
A.8/A.10 Plant and machinery		2,030³	(850)⁵	
Balance	5,428 ²	(912)⁴	(900)⁶	4,796 ²
B.3 Stocks	100	930 ⁸	(810) ⁷	220
Consolidation of assets and liabilities denominated in foreign currencies	Nil	--	--	Nil
Total unrealised	<u>7,038</u>	<u>2,348</u>	<u>(2,560)</u>	<u>6,826</u>
P&L Realised in respect of adjustments on :				
Fixed assets			1,750	1,750
Cost of sales			810	810
MWC			560	560
Gearing			(910)	(910)
Total realised	<u>Nil</u>	<u>--</u>	<u>2,210</u>	<u>2,210⁹</u>
Total	<u>7,038</u>	<u>2,348</u>	<u>(350)</u>	<u>9,036</u>

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Note of explanation on CCR:

1. The unrealised revaluation surpluses on fixed assets and stock become realised by virtue of equivalent entries being passed through the profit and loss account in the form of current cost adjustments. At this time there is a transfer from the *Unrealised* to the *Realised* section of the CCR.
2. These figures represent the difference between the historical cost and value to the business of the assets concerned as shown in A.10 in the workings on fixed assets.
3. Gross revaluation surplus; less
4. Backlog depreciation.
5. Depreciation adjustment.
6. Adjustment on disposal of fixed assets.
7. COSA.
8. In this example this is the derived figure, calculated from the other three. It is the net change in unrealised revaluation surpluses on stock plus the COSA.
9. This is the cumulative total of the CC P&L adjustments since current cost accounts were first prepared. It thus represents the cumulative difference between the HC and CC profits and thereby enables the reconstruction of cumulative HC revenue reserves, which may be of interest for legal purposes.

Based on the above working, a set of current cost accounts is presented as below:

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**Current cost profit and loss account for the
year to 31st December, 1979**

	1979
	<u>Rs.'000</u>
Turnover	<u>64,000</u>
Historical cost trading profit before interest	5,200
Less : Current cost operating adjustments (Note 2)	<u>3,120</u>
Current cost operating profit	2,080
Gearing adjustment	(910)
Interest on net borrowing	<u>1,000</u> 90
Current cost profit before taxation	1,990
Taxation	<u>700</u>
Current cost profit attributable to shareholders	1,290
Dividends	<u>300</u>
Retained current cost profit of the year	<u>990</u>
Statement of Retained Profits/Reserves	
Retained current cost profit of the year	990
Movements on current cost reserve	<u>1,998</u>
	2,988
Reserves at the beginning of the year	<u>12,540</u>
Reserves at the end of the year	<u>15,528</u>
Operating profit: Average net operating assets	6.9%
Earnings per share (Based on average share holding)	Rs. 19.8
Asset value to the business per share (year end)	Rs. 340
Dividend cover, based on CC attributable profit	4.30

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Z Limited

**Summarised current cost balance sheet at
31st December, 1979**

1978		1979	
Rs. '000	Rs. '000	Rs. '000	Rs. '000
<i>Assets employed:</i>			
18,440	Fixed assets		18,808
<i>Net Current Assets:</i>			
6,100	Stock	8,220	
<u>4,000</u>	Monetary working capital (net)	<u>4,500</u>	
10,100	Total working capital	12,720	
(250)	Proposed dividends	(300)	
<u>(2,750)</u>	Other current liabilities (net)	<u>(700)</u>	
	7,100		11,720
	<u>25,540</u>		<u>30,528</u>
<i>Financed by:</i>			
<i>Share Capital and Reserves:</i>			
6,000	Share Capital	7,000	
	Share premium	1,000	
7,038	Current cost reserve	9,036	
5,502	Other reserves and retained profit	6,492	
<u>12,540</u>		<u>15,528</u>	
	18,540		23,528
	6,000 Convertible debentures		6,000
	<u>1,000</u> Deferred tax		<u>1,000</u>
	<u>25,540</u>		<u>30,528</u>