Financial Accounting

Topic 8: Valuation of Shares and Goodwill - Insolvency Accounts Inflation Accounting

INSOLVENCY (BANKRUPTCY)

- Insolvency is the inability of a debtor to pay his debts when they fall due. On the other hand, a person is said to be insolvent when his liabilities are more than his assets and against whom the court makes an order of adjudication.
- In English Law, the terms 'Bankrupt' and 'Bankruptcy' are used in the same sense as the terms 'Insolvent and Insolvency' are used in Indian Law
- When a person becomes heavily indebted and it becomes for him to pay his debt fully, he takes
- Under this act, debtor is exempted from his various debts and his properties are sold under the supervision an official receiver appointed by the court.
- The amount realised by the official receiver by selling debtor's properties is distributed amongst the creditors according to the provisions of law.

Previously in India there were different laws which used to deal with the insolvency & bankruptcy these laws are as follows:

- Presidency Towns Insolvency Act 1909
- Provincial Insolvency Act 1920
- Indian Partnership Act 1932
- The Companies Act 1956
- Sick Industrial Companies (Special Provisions) Act 1985
- Recovery of Debts Due to Banks and Financial Institutions Act, 1993
- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 etc.

For the purpose of making single window clearance some of the Acts mentioned above were deleted & some Acts were amended to get them alien with The Insolvency and Bankruptcy Code, 2016 (IBC).

✓ Introduced in Lok Sabha in December 2015.

✓Passed by Lok Sabha on 5 May 2016 and ✓by Rajya Sabha on 11 May 2016.

✓ Received the assent of the President of India on 28 May 2016.

✓ The Code has 255 sections and 11 Schedules.

The Insolvency and Bankruptcy Code (IBC) 2016 is applicable on each and every company & body corporate operating within India except

Banking, All India Financial Institutions & Non Banking Financial Companies.

Insolvency and Bankruptcy Board of India (IBBI)

Established in 1st October 2016

Headquarters : New Delhi

Chairperson: MS Sahoo.

1. The Presidency Towns Insolvency Act, 1909:

This act applies in the Presidency towns of Mumbai, Chennai and Kolkata. The first insolvency court in the Presidency Towns was established in 1828. This act was amended in 1834. After that in 1848, Indian Insolvency Act was passed. This act was replaced and the new act was passed in 1909. This act is known as Presidency Towns Insolvency Act, 1909, which continues even today.

2. The Provincial Insolvency Act, 1920:

This act applies in whole of India except the presidency towns of Mumbai, Chennai and Kolkata.

OBJECTIVES OF INSOLVENCY LAWS

Following are the main objects of the Insolvency laws:

(i) To give relief to the insolvent debtor from the pressure of his creditors.

(ii) To protect the interests of the creditors.

(iii) To make equitable distribution of property of the debtor among the creditors.

(iv)To enable the debtor to be free from debts and to make a fresh start as soon as he is discharged by the competent court.

Thus, the laws of insolvency are considered as laws

THE PROCEDURE OF INSOLVENCY

1. Presentation of Insolvency Petition: The insolvency

proceedings start from the petition filed by the debtor himself or by his creditors to the competent court for the adjudication of the debtor as insolvent. The petition must be duly supported by an 'affidavit' of the creditor and the evidence of debts and debtors act of insolvency.

2. Appointment of Interim Assignee or Receiver:

The court may appoint interim assignee in case of Presidency Towns Insolvency Act and interim receiver in other places. The interim assignee or

3. Order of Adjudication: If the court is satisfied, it may pass an order declaring the debtor as insolvent. Such order is called 'Order of Adjudication'. The official receiver realises the debtors property and distributes the same among the creditors equitably.

4. Discharge of Insolvent: This is the last stage in the insolvency proceedings. A debtor can apply to the court for an order of discharge within the period specified by the court after the order of adjudication. An order of discharge by the court shall release the insolvent from all debts and his

Effects of Order of Discharge

An order of discharge shall release the insolvent debtor from all debts provable under the act, but it will not release the insolvent from :

(i) Any debt due to the government,

(ii) Any debt or liability incurred by means of fraud to which he was a party.

(iii) Any debt of liability in respect of which he has obtained for bearance by any fraud to which he was a party.

(iv) Any liability under an order for maintenance made under section 488 of the code of Criminal

ACCOUNTING PROCEDURE

When a debtor is adjudicated as insolvent, he is required to submit to the official receiver a **'Statement of Affairs'** supported by a schedule known as **'Deficiency Account'.** The statement of affairs show the estimated financial position of the debtor while the deficiency account explains how he has arrived in that position.

There are two sides of Statement of Affairs:

I. Liabilities Side

II. Assets Side

I. Liabilities Side

Liabilities side is concerned with creditors. It is divided into four parts and for each part separate four lists are prepared which are as follows:

1. List 'A': For Unsecured Creditors

2. List 'B': For Fully Secured Creditors

3 List 'C': For Partly Secured Creditors

4. List 'D': For Preferential Creditors

II. Assets Side

The assets of the insolvent debtor are classified into three categories and shown under different lists as follows:

1.List'E' Properties

2.List F: Book-debts.

3.List 'G' : Bills Receivable and Promissory Note

4.List 'H' :Deficiency

Statement of Affairs (As required by the Indian Insolvency Act) In the Court of Justice In insolvency

Gross Liabilities (Rs.)	Liabilities (as stated and estimated by the debtor)	Expected To rank	Assets (as stated and estimated by the debtors)	Book Value	Estimated to produce
	UnsecuredCreditors as per List A Fully Secured Creditors as per list B Less: Estimated value of Securities Less: Amount thereof carried to List C Balance thereof contra		Property as per List E, viz. Cash at Bank Cash in hand Cash deposited with solicitor for cost of petition Stock in trade a Machinery		

	Partly secured creditors as per List C Less: Estimated value of Securities Preferential Creditors as per List D (Creditors for rent, taxes, salaries and wages, etc.) payable in full as per contra		Trade Fixture, Fitting Utensils, etc. Furniture Life Insurance Policies Other property Book debts as per list F. viz. Good Doubtful Bad Estimated to produce Bills of exchange or other similar Securities on hand as per List G Estimated to produce Surplus from securities in the hands of creditors fully secured (per contra) Deduct: Creditors for preferential rent, rates, taxes, wages, etc. per contra) Deficiency as per explained in List H		

1. List A-Unsecured Creditors as per List A:

This list includes all Creditors, who do not possess any security of the Insolvent Debtor. That is, the Creditors without security fall under this list.

Some of such Creditors are:

- Trade Creditors without security op
- Loan Creditors without security
- Bank Overdraft unsecured
- Bills Payable and Promissory Notes
- Bills Receivable discounted likely to be dishonoured
- Salary, Wages, Rent etc. over Preferential limit.

2. List B-Fully Secured Creditors:

This list includes all the Creditors, who have a claim against the debtor and have obtained a lien, guarantee or possession of some deeds or other securities. That is, the creditors, who have sufficient securities of the insolvent Debtor to meet their claims.

The value of the securities may be equal to or more than the amount of their claims. If there is any surplus of securities in the hands of fully secured creditors, such surplus will be shown on the asset side of the Statement of Affairs and will be available for distribution among the unsecured Creditors.

3. List C-Partly Secured Creditors:

There are certain Creditors, who have the security for a lesser value than the amount of their claims. That is, the Creditors of this type got only partial security for the loan advanced by them. The securities are insufficient to meet the claims.

For instance, a loan of Rs 10,000 has been taken and the security for this loan is only Rs. 6,000. So, the loan is partly secured. The value of the security is not sufficient to cover their claims fully. The excess of loan over the security is shown in the outer column

4. List D-Preferential Creditors:

This list shows the Preferential Creditors, who are entitled to priority over other debts of the insolvent.

Generally the following liabilities are included in this list:

1. Debts Payable to Government : Debts due to government, local authority such as, Income tax, Gift tax, Wealth tax, House tax, Sales Tax and local taxes etc. are considered in it.

2. Legal Obligations: Amount payable under workman compensation act or under anyother act is included in this list.

3. Salary of Clerks: Salaries of clerk in respect of services rendered to the insolvent. during four months before the presentation of the petition.

4. Wages of Labourer or Servant: Wages of labourer or servant in respect of services rendered to the insolvent during four months before the presentation of the petition.

5. Rent Payable to Landlord: Rent payable to the landlord is included in this list. The amount of preferential creditors is not shown in expected to rank column, it shown in inner column. Although, it is shown in gross liability column.

The following are the lists shown in the asset side of the Statement of Affairs:

5. List E-Properties:

This is a list which includes all the assets of the Insolvent, except Book Debts, Bills Receivable and assets which have not been given as security to Creditors. Here all the assets unencumbered properties i.e., free assets are shown. For instance, Cash in hand, Cash at Bank, Furniture, Machinery etc. Both book value and realisation value are shown.

6. List F-Book Debts:

All the debtors of the insolvent are shown in this list. Good, Doubtful and Bad debts are shown separately.

7. List G-Bills of Exchange etc.:

This list contains the information about Bills Receivable and Promissory Notes. The book value and the realizable value are shown separately.

8. List H-Deficiency Account:

This list shows the deficiency i.e., liabilities of the Debtors over realizable value of his assets. For this purpose a separate Deficiency Account is prepared. Now, after writing the Lists E, F and G, the surplus, as per List B, appears on the liability side, is added to the assets. From this amount, the Preferential Creditors as per List D are deducted. The balance, so arrived, is the amount of assets available for distribution among the Creditors.

	AMOUNT (RS)		AMOUNT (RS)
Excess of Assets over liabilities i.e. capital on Net profit arising from carrying on business after deducting usual trade expenses, income or profit from other source i.e.		Excess of Liabilities over assets Net Loss arising from carrying on business after deduction from profit, usual trade expenses Bad debts as per list F	

Interest on capital Excess of private assets over private liabilities Profit on realization of any assets Deficiency as per statement of Affairs		Expenses incurred since........ Other than usual trade expenses, viz. House hold expenses (Drawings) Other Losses Loss on realization of Asset Loss through dishonor of discounted bills Speculation losses, Losses through betting Excess of private liabilities over private assets, etc.	

Priority of Payments:

(a) firstly, thecosts expenses and incurred by the bankruptcy trustee for the bankruptcy process in full

(b)secondly, (i) the workmen's dues for the period of twenty four months preceding the bankruptcy commencement date; and (ii) debts owed to secured creditors;

(C) thirdly, wages and any unpaid dues owed to employees, other than workmen, of the bankrupt for the period of twelve months preceding the bankruptcy commencement date;

(d) fourthly, any amount due to the Central Government and the State Government including the amount to be received on account of Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period f two years preceding the bankruptcy commencement date

(e) lastly, all other debts and dues owed by the bankrupt including unsecured debts

VALUATION APPROACHES TO ACCOUNTING

- Historical cost accounting
- Current value systems/Fair value accounting
- General price-level adjustment / Inflation accounting
- Discounted cash flows

Inflation means an upward change in the prices of goods and services of general consumption. Prices reflect the value of goods and services in the economy. Price changes occur when the price of goods and services vary from what they were previously.

Under historical cost accounting the profit figure is derived by matching costs against current revenues. Such costs are historical and not current costs. For example, depreciation, purchases, etc. are shown at historical costs. This results in under statement of cost and over statement of profits.

Limitations of Historical cost accounting

1. Failure to disclose the current worth of the enterprise

2. Incomparable items in financial statements

3. Difficult to replace fixed assets

4. Inaccurate determination of profit

5. Mixing up of holding and operating profits

INFLATION ACCOUNTING

- .A range of accounting methods designed to correct problems arising from historical cost accounting in the presence of high inflation and hyperinflation
- Also called price level accounting
- Similar to converting financial statements into other currency using an exchange rate
- IAS 29 requires implementation of inflation accounting for corporations in countries experiencing hyperinflation

Objectives of Inflation Accounting

→ To eliminate distortions in financial statements that arise due to the use of historical cost
→ To provide for more meaningful inter-period comparisons
→ To improve the meaning and measurement of income and expenses in the face of the changing purchasing power of money
→ To improve decision-making in the organization

Need for Inflation Accounting

i) Inflation adjusted profit:

Traditional historical cost based accounting does not adjust to income, depreciation and materials charges at current price levels. This results in higher book profits. If these are distributed to shareholders as dividends, it can lead to capital erosion.

ii) Replacement of assets:

Traditional historical cost based accounting provides for depreciation that is inadequate to finance the replacement of depreciated assets Here by replacement it is not generally meant the replacement of one asset by an identical second asset. We mean replacement of the operating capability represented by asset that needs replacement.

iii) Maintenance of real value of capital;

In traditional accounting although capital is maintained in nominal money terms, it may not be maintained in real terms. Profit calculated after maintaining capital only in nominal money terms is not real profit, especially under inflationary conditions. Any decision taken on this 'paper profit' is misleading.

iv)True and Fair view:

Primary objective of Financial Statements is to provide true and fair view of the profit and loss for the accounting period and true and fair value of assets and liabilities as at the end of the period. These objectives are not achieved under historical cost based accounting.

v)Effective comparison

Comparison of the profits earned by a company over years is rendered useless by accounting based on historical costs. A company earning a profit of, say Rs. Five crores four years ago, and Rs Ten crores now; cannot be said to have improved its profitability, because shareholder is likely to find that with Rs Ten crores now, he may not be able to buy what he would have bought with only Rs Five crores four years ago!

IAS 29: Financial Reporting in Hyperinflationary Economies

- Effective date: Annual periods beginning on or after January 2005
- The financial statements in a currency of a hyperinflationary economy are stated in the end-of-period measuring unit current
- Comparative figure for prior periods are restated into the same current measuring unit

- The gain or loss on the monetary position is included in profit and loss
- An economy is hyperinflationary if the cumulative inflation rate over three years exceeds 100% (one of the necessary conditions)

- International Monetary Fund (IMF) publishes inflation forecasts as 31 December 2021

Argentina Islamic Republic of Iran Lebanon

South Sudan Sudan Suriname

Syrian Arab Republic Venezuela Yemen

Zimbabwe

METHODS OF INFLATION ACCOUNTING:

Some of the generally accepted methods of Inflation accounting are as follows -

(a) Current Purchasing Power Method (CPP Method)
(b) Current Cost Accounting Method (CCA Method)

(c) Hybrid Method

Current Purchasing Power Method OR Constant Rupee Method (CPP Method)

- Under CPP method, all items in the financial statements are restated in terms of units of equal purchasing power.
- The CPP method basically attempts to remove the distortions in financial statements, which arise due to change in the value of rupee.
- CPP method distinguishes between monetary and non-monetary items.

Steps in CPP Method:

Under CPP method, financial statements prepared under historical cost accounting are re- stated by using an approved price index.The following steps should be followed to prepare financial statements under CPP method:

- Calculation of conversion factor.
- Distinction of gain or loss on monetary items.
- Calculation of gain or loss on monetary items.
- Valuation of cost of sales & inventories.
- Ascertainment of profit.
- Preparation of re-sated balance sheet.

Calculation Of Conversion Factor

Value of asset as per CPP =

Historical Cost of Asset x Conversion Factor

Conversion Factor=

Price Index at the date of conversion

Price at the date of transaction

Calculation Of Conversion Factor

A company purchased a plant on 1/1/2005 for a sum of Rs. 45,000. The consumer price index on that date was 125 and it was 250 at the end of the year. Restate the value of the plant as per CPP method as on 31st December 2005.

Conversion Factor =

Price Index as on 31/12/2005 = 250 = 2

Price Index as on 1/1/2005 125

Value of the plant on 31/12/05 =

Historical Cost x Conversion Factor

Rs 45,000 x 2 = Rs 90,000

Monetary Vs Non Monetary Items:

- Monetary Items (both assets and liabilities) are those items whose amounts are fixed by contracts or otherwise they remain constant in terms of monetary units. Example debtors, creditors, debentures, Preference share capital etc.

- .During the period of inflation the holder of monetary assets lose general purchasing power since their claims against the firm remain fixed irrespective of any changes in the general price levels. Conversely, the holder of monetary liabilities gains since he is to pay the same amount due in rupees of lower purchasing power.

- Non monetary items are those items that cannot be stated in fixed monetary amounts. They include tangible assets such as building, plant & machinery, stock etc.

- Under CPP method all such items are to be restated to represent the current purchasing power. For example a machinery costing Rs 25,000 in 1996 may sell for Rs 35,000 today though it has been used. This may be due to change in the general price level.

- Note Equity capital is a non monetary item since the equity shareholders have a residual claim on the company's net assets.

Computation of Monetary gain or loss:

- The changes in purchasing power affects both monetary and non monetary items of the financial statements. In case of monetary assets and monetary liabilities, the firm receives or pays the amounts fixed as per the terms of the contract, but it gains or losses in terms of real purchasing power.
- Such monetary gain or loss should be computed separately and shown as a separate item in the restated income statement in order to find out the overall profit or loss under CPP

method.

Purchasing Power Gains & Losses

State of the Enterprise	Inflation	Deflation
Net Monetary Asset Position	Purchasing Power Loss	Purchasing Power Gain
Net Monetary Liability Position	Purchasing Power Gain	Purchasing Power Loss

Illustration:

. From the following data calculate net monetary gain / loss as per CPP method -

Item	1/1/2018	31/12/2018

Cash	Rs. 5000	Rs 10000
Debtors	Rs. 20000	Rs.25000
Creditors	Rs. 15000	Rs. 20000
Public Deposits	Rs. 20000	Rs. 20000

Consumer Price index numbers are -

On 1/1/2018	-- 200
On 31/12/2018	-- 300
Average for the year	-- 240

Solution :

• Impact on Assets:

• Assets as on 31/12/2018 = 35000 out of which 25000 are opening and rest 10000 are additions during the year.

• Value of assets as per CPP =

25000 x 300 / 200 =	37500
+ 10000 x 300 / 240=	12500
	50000
Less: Value of assets as per closing B/S	-35000
Resultant monetary Loss	15000

• Impact on Liabilities:

• Liabilities as on 31/12/2018 = 40000 out of which 35000 are opening and rest 5000 are additions during the year.

• Value of liabilities as per CPP

	35000 x 300/200 =	52500
	+ 5000 x 300/240 =	6250
		58750
Less: Value of liabilities as per closing B/S		- 40000
Resultant monetary gain		18750
Net monetary Gain =		
Monetary gain from liabilities		18750
Less: Monetary loss from assets		15000
Net Monetary gain =		3750

Adjustment for cost of sales and Inventories:

The restatement of the Cost of Sales and inventories under the CPP method, depends upon the method used for accounting for inventories (FIFO or LIFO).

Under FIFO method, the cost of sales normally includes the entire opening stock and current purchases less closing stock. Closing stock comprises latest purchases.

Under LIFO method, the cost of sales normally includes the latest purchases and the closing comprises the earliest purchases.

Ascertaining the values of cost of sales and closing stock as per CPP method

	Amount	Index
Stock on 1-1-18	10000	200
Purchase in 2018	50000	240
Stock on 31-12-18	15000	300

FIFO Method	HC		CPP
Opening stock	10000	300/200	15000
Add: Purchases	50000	300/240	62500
Less: Closing	-15000	300/240	-18750
Cost of Goods sold	45000		58750

Ascertaining the values of cost of sales and closing stock as per CPP method

	Amount	Index
Stock on 1-1-18	10000	200
Purchase in 2018	50000	240
Stock on 31-12-18	15000	300

LIFO Method	HC		CP
Opening stock	10000	300/200	15000
Add: Purchases	50000	300/240	62500
Less: Closing	(10000)	300/200	(15000)
	(5000)	300/240	(6250)
Cost of Goods sold	45000		56250

Ascertainment of profit by Re-statement of income method

Under this method, historical income statement is re-stated in CPP terms. Following conversion factors are used to restate the figures of historical cost statement.

a.Sales and operating expenses are converted at the average rate application for the year.

b. Cost of sales converted as per cost flow assumption i.e. FIFO and LIFO.

c. Depreciation is converted on the basis of indices prevailing on the date when fixed assets were purchased.

d. Taxes and dividend paid are converted on the indices that were prevalent on the dates when they were paid.

e. Gain or loss on monetary items should be shown as a separate item to arrive at the overall profit or loss

Restated Balance Sheet

The historical balance sheet is prepared as per the historical income statement, so it can not represent the revised or changed values of assets and liabilities. Under the price level change, the historical balance sheet should be revised to reflect the true pictures of financial position of any organization.

LIMITATIONS OF CPP METHOD

- The index numbers are statistical averages and the CPP method is based on indices. Hence, it would be very difficult to apply with precision to individual firms.

- There are various price indices, which characterize different price situations. Hence, it would be a difficult task to select a suitable price index.
- The method deals with changes in the general price level and not with the changes in prices of individual firms. However, the only relationship is that the individual prices move with the general price index to some extent. Hence, a large number of accountants, economists, and Government authorities do not favor this method.

CURRENT COSTING ACCOUNTING (CCA) APPROACH

- Current costing method is an alternative to CPP method.

- To overcome the difficulties of CPP method, CCA approach was introduced in 1975 in Britain.
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- Actually the CPP method applies the retail price index for finding out the conversion factors to restate the income statement and balance sheet.
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- In 1980 accounting committee of UK government finalised the CCA approach by issuing standard accounting practice

Features Of Current Cost Accounting (CCA)

1. The fixed assets are recorded at replacement cost value in the balance sheet.

2. Inventories are shown at market value rather than market or cost price whichever less as in the historical system is.

3. Revaluation surplus are transferred to current cost but not distribute accounting reserve but not distributed as dividend to shareholders.

4. Depreciation of fixed assets is to be calculated at replacement value.

5. Two types of profit i.e. profit from operation and profit from revaluation are calculated.

6. Liabilities are recorded in their original value because there is no any change in monetary unit.

Accounting profit under CCA is divided into three parts as follows:

a. Current Operating Profit = Sales proceeds of goods and services sold - Replacement cost of goods or services sold.

b. Realised Holding Gain = Replacement cost of non monetary asset sold on date of sale - Historical Cost.

c. Unrealised Holding Gain = Replacement cost of non monetary asset on closing date - Historical Cost

Adjustments for calculation of Current Operating Profit

The following adjustments are to be made in calculation of the Current Operating Profit under CCA method:

1. Current Cost Adjustments

   a. Depreciation Adjustment

   b. Cost of Sales Adjustment (COSA)

   c. Monetary Working Capital Adjustment (MWCA)

2. Gearing Adjustment

ENTRI

Depreciation Adjustment

Under this method, depreciation is debited to profit and loss account on the basis Current Value or Replacement Cost of the fixed assets.

The current depreciation charge is obtained under this method by apportioning average net replacement cost over expected remaining useful life of fixed asset at the beginning of the period

Backlog Depreciation- If fixed assets are revalued every year, there will be short fall of depreciation. Such depreciation is called backlog depreciation. The backlog depreciation is debited to the Current Cost Reserve or adjusted against the Revaluation Reserve on the fixed assets.

Backlog Depreciation

Backlog Depreciation=

Gross Replacement cost - Net Replacement Cost - (Previous accumulated depreciation asper HCA+ Depreciation for the Current Year asper CCA)

A firm is using machinery with historical gross value of Rs. 80000 and the accumulated depreciation of Rs. 32000 including Rs. 8000 depreciation for the current year. The gross replacement cost of the machine is Rs. 100000 and it is estimated that its remaining useful life will not change. Calculate the backlog depreciation.

Backlog Depreciation

	HCA	CCA
Value of Machine	80000	100000
Current Depreciation	8000	10000
Previous Accumulated Depreciation	32000	40000
Total Accumulated Depreciation	40000	50000
Net Value	40000	50000

Backlog Depreciation=

Gross Replacement cost – Net Replacement Cost – (Previous accumulated depreciation as per HCA+ Depreciation for the Current Year as per CCA)

=100000-50000 - (32000+10000) = 8000

Cost of Sales Adjustment (COSA)

Cost of Sales Adjustment refers to the difference between value to the business and the historical cost of stock consumed in the period. COSA can be calculated as follows

$$COSA = (C - O) - I_a\left(\frac{C}{I_C} - \frac{O}{I_O}\right)$$

C = Historical cost of Closing Stock
O = Historical cost of Opening Stock
Ia = Average Index No. for the period
Ic = Index No. appropriate to closing stock
Io = Index No. appropriate to Opening stock

Monetary Working Capital Adjustment (MWCA)

Monetary Working Capital Adjustment (MWCA) is the difference between trade debtors and creditors. MWCA shows the effect of changes in prices arising from volume. MWCA can be calculated as follows:

$$\text{MWCA} = (C - O) - I_a\left(\frac{C}{I_C} - \frac{O}{I_O}\right)$$

C = Closing Monetary Working Capital
O = Opening Monetary Working Capital
Ia = Average Index No. for the period
Ic = Index No. appropriate to closing Monetary Working Capital
o = Index No. appropriate to opening Monetary Working Capital

GEARING ADJUSTMENT

- Gearing is the ratio of borrowed capital and shareholders' funds. Fixed assets and working capital are partly financed by borrowed capital and partly by shareholders' funds.
- During inflationary period the replacement cost of assets exceeds the borrowings that has financed by them.

- In the period of rising prices the shareholders get more benefits because any increase in price will provide more benefit to shareholders.
- The position would be reverse during deflation. Total of current cost adjustments is abated by gearing adjustment.

Gearing adjustment and gearing adjustment ratio can be calculated as follows:

$$\text{Gearing Adjustment} = \frac{L}{L+S} \times A$$

$$\text{Gearing Adjustment Ratio} = \frac{L}{L+S} \times 100$$

L = Average Net Borrowing

S = Average Shareholders' Funds

A = Total of Current Cost Adjustments