# ACCOUNTING & INFLATION
# AN EXAMINATION OF REPLACEMENT COST

By Marc Desmarchelier A.C.A., A.A.S.A.(Sen.), A.S.I.A., Director of Administration, Hungerfords
Leigh Hall B.Ec., A.C.A., A.A.S.A., F.A.I.I., A.C.I.S., A.S.I.A., Investment Officer, A.M.P. Society
Ray Willing B.A.(Econ.), B.A.(Math.), A.S.I.A., Investment Manager, N.R.M.A.

## 1. INTRODUCTION

The Australian accounting bodies have prepared a preliminary exposure draft on "A method of Current Value Accounting". Comments have been invited upon this draft and upon the earlier draft on "A method of accounting for Changes in the Purchasing Power of Money". Comments are to be submitted by the end of December, 1975.

The recent exposure draft claims that it is a method based on what has been described as Specific Price Change Accounting. As the method is a form of replacement cost accounting, it will be referred to for the rest of the paper as R.C.A., so as not to confuse it with methods of accounting showing current values.

The effects of inflation on corporate profits and liquidity and the failure of traditional accounting methods to adequately disclose the consequences of changes in the purchasing power of money are two of the most vital problems facing the business community. Members of the Securities Institute being important users of company accounts should make their views known.

Implicit in any change in accounting methods is the necessity to change taxation laws. Taxation must follow sound accounting rules.

The latest exposure draft is examined below and we then discuss those aspects required to make for a more useful means of accounting.

## 2. SCHOOLS OF THOUGHT

There are many methods of accounting which seek to deal with changes in purchasing power: four important schools of thought are listed below:–

(i) C.P.P. (current purchasing power) – the first Exposure Draft; broadly, C.P.P. deals with changes in the general level of prices but disregards changes in the structure of prices: this method adjusts historical cost by an index.

(ii) C.V.A. (current value accounting) – the second Exposure Draft; in general terms, C.V.A. is directed towards changes in the structure of replacement costs; it disregards the effect of changes in the general level of prices; it disregards the effects of inflation/deflation upon monetary items.

(iii) Across the board C.V.A., which recognizes monetary items.
One sub school is concerned with the notion of "Entity"; roughly, the idea is to maintain a sum of capital sufficient to secure enough resources to preserve a quantum of production or services.
The second sub school is concerned with "proprietorship"; here, capital is maintained intact by reference to a quantum of capital, measured by a general index.

(iv) C.C.A. (continuously contemporary accounting); based substantially on market values, C.C.A. deals both with changes in the general level of prices and with changes in the structure of prices; to assist in evaluation, it also employs a simple mechanism which enables past results to be restated in units of current purchasing power.

## 3. DESCRIPTION OF THE REPLACEMENT METHOD

Whereas the C.P.P. draft proposes the establishment of supplementary accounts, the R.C.A. method would be incorporated in the actual accounts of the enterprise.

It adopts the use of replacement values in stating most assets in the balance sheet. Profit measurement is based on the principle of matching revenue and expenses, both expressed in "current" terms.

Balance sheet items are shown according to the following bases (provided the entity can be considered a going concern):

| | |
|---|---|
| monetary assets | – at net realisable value. |
| inventories | – at replacement cost, except where this is not suitable as in the case of some fashion goods where net realisable value is used. |
| land | – at replacement value where it is essential to the continuing operations. |
| | – at net realisable value where it is not essential. |
| depreciable assets | – at replacement cost where essential |
| | – otherwise at net realisable value. |
| accumulated depreciation | – adjusted to reflect the expired service potential of the particular assets on the basis of their replacement cost at balance date. |
| investments | – at replacement cost where ascertainable, and otherwise at equity method carrying amount. |
| deferred charges and prepayments | – at recorded amounts. |
| liabilities, provisions & accruals | – at recorded amounts. |

If an entity or any segment is not considered to be or to remain a going concern, the assets of that entity or segment will be valued at net realisable value.

In ascertaining the profit or loss for the period:

- cost of goods sold will be the replacement cost of the goods at the time of sale (approximately the average replacement cost during the period).
- depreciation will be based on the average replacement cost for the period of the depreciable assets held.

When values are rising credits will be made to a revaluation reserve in respect of inventories, plant, land and buildings.

An adjustment will be made to accumulate depreciation so that its total properly reflects the used up or expired service potential of the depreciable assets, expressed in terms of current replacement cost at balance date. In the case of a deficiency the amount will be provided from retained earnings.

A reconciliation of the change in shareholders' equity will be presented.

## 4. ADVANTAGES CLAIMED FOR REPLACEMENT COST ACCOUNTING

It provides information which is more useful and up to date than that resulting from historical cost accounting.

It shows whether a company is capable of maintaining by total replacement the physical capacity of its resources. This information will assist management in its forward planning.

The method can enable the improvement of a company's liquidity through the determining of a lowered distributable profit arising as a result of increased depreciation charges and lowered profits on holding inventories. This may then dissuade competitors, customers, the P.J.T. and unions from rejecting the company charging realistically higher prices for its products.

It will provide a more uniform basis for comparing companies in the same industry and a better basis for general inter-company comparisons.

Managers use replacement cost when reviewing insurances, considering plant replacement, and in determining costing and pricing.

5. SOME DISADVANTAGES OF REPLACEMENT COST ACCOUNTING

The method does not deal with inflation as such.

The method assumes that an existing asset will be replaced. However, most businesses do not stand in contemplation of replacing their assets at every balance date. Replacement is a new investment decision. When management plans replacement of an expensive item, it is important that this information be conveyed to the participants.

This element of subjectivity could obviously lead to abuse. Because of this subjectivity the abuse can arise unwittingly even where management wishes to be scrupulously honest.

Less reputable managers can markedly alter the apparent financial situation by choosing whether the asset is to be replaced or not and by altering its life expectancy.

Some claim that R.C.A. is a time consuming process, but we did not accept that argument.

The accounts are not and cannot be indicative of the actual consequences of past action.

The concept of capital maintenance based on operating capacity is essentially an entity view as opposed to a proprietorship one. Implicit in the draft is the notion of a continuing entity; however, current values would allow investors a clear choice between alternative investments.

Replacement cost is the price of an asset which the company does not own.

In contemplating effecting a replacement change, a decision maker must know the alternatives available and also, the means available to the corporation. The available alternatives give the range of replacement values. The means available are the realisable values of the assets which are expected to be exchanged or borrowed against. A system of accounting which ignores available means is grossly deficient.

R.C.A. is concerned with physical assets and capacities, whilst accounts should present financial features of the firm in order to meaningfully convey the present position or the results of past operations.

R.C.A. does not specifically account for the maintenance of working capital in real terms.

Results of different periods are not directly comparable because the accounts are prepared in terms of different purchasing power.

R.C.A. does not credit a company for holding the right materials at the right time.

Replacement cost accounting has little relevance for non-manufacturing companies, such as banks and insurance companies.

Some other important disadvantages are discussed in the sections below.



6. MONETARY ITEMS

The exposure draft in Paragraph 25 states that the subject of gains and losses on monetary items needs further study before any firm recommendations could be made in relation thereto. It is true that monetary assets will have less purchasing power after a period of inflation and that monetary liabilities will be repaid in money with less purchasing power. The cash equivalent of all assets will be in money of different purchasing power at the end of an inflationary period. In comparing the value of an asset between two period, the real difference will be due to a specific price change for that asset; but the monetary change will include a proportion due to the general change in purchasing power. Were a reliable index of change in purchasing power to be available, investors would benefit by knowing the separate components of any change: that due to market forces and, separately, that due to changes in the general level of prices.

7. DEPRECIATION

Under historical cost accounting, depreciation is based either on an amortisation of past costs or on assessed replacement cost. When prices are rising, depreciation based on past costs will not be sufficient to provide for replacement at current cost. The draft proposes that assets be restated at replacement cost, that depreciation be also restated, based on the adjusted price and paying regard to past period in use; this depreciation gap is to be charged against retained earnings.

It can be argued that this apparent difference is not a depreciation gap but, rather, an investment gap due to an inability to invest the retained funds in assets whose value keeps pace with equipment prices.

It can be shown that if a company is regularly re-investing in plant, and is regularly providing tor usual replacement, there will be sufficient funds provided in each year.

Generally, the draft is inconsistent in its treatment of depreciation. It allows companies to value some depreciable assets at net realisable value and others at replacement price with the concomitant restatement of the depreciation.

In practice, corporations do not normally contemplate replacement of all operating assets at each balance date. In any case, the corporations' capacity to effect an exchange, the means available, is a vital piece of information.

8. TAXATION

R.C.A. would not be a suitable basis for the determination of taxable income because those enterprises which experience escalating stock prices and escalating plant costs will build up the equity of the owners at a faster rate than for owners of enterprises experiencing lower rates of escalation. A common basis of income determination must be found.

9. ANOTHER METHOD IS REQUIRED

It appears to the authors that neither the C.P.P. or the R.C.A. exposure drafts are suitable. Historic cost accounts cannot, of course, even be considered.

We comment below on some aspects of another method.

## CURRENT VALUE ACCOUNTING

1. WHAT USERS REQUIRE

The objective of financial statements for business enterprises has been defined as that "to communicate information concerning the nature and value of the economic resources of a business enterprise, the interests of creditors and the equity of owners in the economic resources and the changes in the nature and value of those resources from period to period".

There is a need to provide that useful information which will best enable the making of rational investment decisions. Accounts should enable the prediction of cash flow and earning power. Shareholders will also need to know such non-accounting information as the major enterprise goals so that they may judge management's ability to attain those goals. It was once assumed that the interests of shareholders were identical with those of a company and its management, but as ownership and control have become divorced this is no longer so. A shareholder needs to be able to ascertain stewardship of management. A shareholder's involvement is only that of a financial investment which may be switched.

Thus it is that accounts should primarily disclose the actual situation as at a point in time and of the actual changes between two points in time.

2. VALUATION CONSIDERATION

Value should be in terms of the currency pertaining at balance date. Assets are those items legally held in possession which could be separately appropriated or otherwise dealt with. These assets would be valued at net realisable prices in the normal course of business. They would not be valued at forced sale price.

Goodwill of the business would not be shown as an asset.

Liabilities are shown in those monetary units which are contractually due to be paid, or which are expected to become contractually due, regardless of the due date of payment.

However, there may be situations where the liabilities would be shown at their current cash equivalent which would be market price where relevant or in other instances the amount the creditors are prepared to accept in full settlement, or the amount the borrower has to offer a financial specialist to divest himself of the liability. The amount could therefore be higher or lower than the face value of the liability.

3. PROFIT DETERMINATION

The gross gain or loss for a period is the difference between the net wealth at the end and start of the period.

It is desirable that the change in net wealth be broken down to indicate separately:—

- Income from trading
- Income from investments
- Other sporadic income
- Gains or losses due to changes in the value of non-trading assets

4. ACCOUNTING FOR INFLATION

Stewardship reporting requires a corporation, in determining its surplus, to maintain its net wealth in units of comparable purchasing power; simply, this can be achieved in each period by transferring to a capital maintenance account an amount, calculated by reference to an appropriate index of general prices, sufficient to do this. This calculation would be made on the net wealth at the commencement of the period.

## HOW THE TREASURY SEES IT – INFLATIONARY PROFITS

(Treasury Taxation Paper No. 15, July 1975)

*"Some of the public debate on the question refers to the cash flow position of businesses during inflation. For example, businesses can become desperately short of working capital and yet still be regarded as having made profits and be taxed on them when in fact they cannot find the money to pay dividends. It is argued that there must be something wrong with the status quo in the taxation area if it can lead to such apparently paradoxical results.*

*Arguments of that kind can have a strong emotive appeal without necessarily getting down to the real causes of the problems. In particular, any slowness on the part of businesses, due to their own accounting practices, to adopt pricing policies which reflect the increasing costs of holding stock and replacing capital assets, or any externally imposed constraints on the pursuance of such pricing policies (e.g. constraint imposed by the Prices Justification Tribunal), will produce consequences of this kind. While it is a truism to say that businesses would be better off if they paid less tax, it does not follow that a cause of any problems they have can be found in the taxation system."*