INFLATION AND ACCOUNTING - A CHALLENGE TO CHANGE

By C.J. Jackman, M.A., F.C.A.,
Price, Waterhouse & Co.,

1. INTRODUCTION

Accounting services are defined as those services designed to assist mankind's management, allocation and use of economic resources. At present the accounting profession has a big challenge before it which has largely come about because of inflation and the difficulty to arrive at acceptable financial information expressed basically in historical cost terms. There is a challenge to change the basic concept from historical cost and to continue the alliteration it is comparable to the challenges previously imposed by consolidations, cost accounting and computers. That challenge is constant purchasing power (CPP) and current value accounting, whether expressed in terms of replacement cost or net realisable value.

While the challenge has arisen because of inflation, CPP and current value accounting are not alternative methods of accounting for inflation. They result from different concepts and are not mutually exclusive. Basically CPP accounts stick with the historical cost concept and adjust for the general level of inflation. Current value accounting introduces a new concept of capital maintenance, that of operating capability and accordingly, places its emphasis on replacement cost. If replacement costs achieve similar results to CPP accounts it is coincidental.

A recent discussion paper issued by the Institute of Chartered Accountants in England and Wales has suggested that the fundamental objective of corporate reports is to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information.

In considering those users of corporate reports that have a reasonable right to information concerning the reporting entities one can identify the equity investor group, the loan creditor group, the employee group, the analyst/advisor group, the business contact group, the government and the public. There has also been a trend towards the acceptance by business enterprises of multiple responsibilities. Distributable profit is no longer the only indicator of performance in the corporate reports of such entities.

It may well be that there is no one system of measurement which is capable of meeting all the user needs. There are proposals for meeting user needs perhaps by a multi-column presentation. However, this suggestion involves a large change in accounting practice and may fail a test of usefulness if understandability is impaired.

2. DIFFERENTIATION OF CONCEPTS

It is important to recognise that current value or replacement cost accounting is not an alternative to current purchasing power, CPP accounting. One debate should be on the relative merits of historical cost accounting, replacement cost accounting and other alternatives to historical cost accounting. The second debate is between historical currency and currency of current purchasing power as units of measurement. Thus much discussion centers around terms such as a definition of profit, capital maintenance and unit of measurement.

Under historical cost accounting profit is revenue less the amount required to maintain the owners money capital originally invested. On the other hand, replacement cost accounting defines profit as revenue less the amount required to maintain a company's physical assets. This concept of maintaining the operating capability of the entity is an important distinction and for those organisations to which it applies is often a necessary part of staying in business, as it is not always possible to raise capital when it is needed.

CPP accounting is a method of adjusting historical currency for the debasement of the currency as a unit of measurement. The CPP approach can accordingly be applied to both historical cost and replacement cost accounting to demonstrate that the capital is maintained not only in terms of constant purchasing power but also in terms of operating capability.

In considering profit we must also consider that it can be defined as the difference between the net assets at the beginning and end of the period after adjustments for capital and dividends. It is likely that development in accounting thinking will be towards the adoption of such a basis determined by values of assets and liabilities. However, values are often dependent on expectations of future events and are to a large extent subjective. Accordingly for the present there appear to be too many practical difficulties associated with the adoption of current values for it to be adopted as a standard system.

3. PRACTICAL PROBLEMS CPP ACCOUNTING

CPP accounting has already received much attention in many countries of the world and the procedures are fairly well established. While time is involved, there are few practical problems in implementing CPP. CPP accepts the historical cost conventions to which we are accustomed and adjusts them for the general purchasing power. The brief guide to the Sandilands report says that the unit of current purchasing power is likely to be conceptually difficult for most users of accounts to understand. This conceptual difficulty is probably the real reason for the committee's view and it seems to have coloured the whole of their approach to the subject of inflation accounting. As a result of exposure drafts, public debate, professional development courses and the publication of accounts adopting CPP many users of accounts are now beginning to understand the concept and it would be a great pity to abandon it just at the point of understanding.

One subject which has not received much attention in the interpretation of financial statements re-stated for price level changes.

This gathering consists of people whose business is to interpret financial statements and your challenge is to make constructive use of such information just as you already do with present financial statements prepared on the inadequate basis of historical cost. Certain suggestions on the interpretation follow and you will be able to add many more.

Financial statements restated for price level changes are based on historical cost data, but when an explanatory comparison is made between historical cost financial statements and price level stated financial statements information is furnished regarding:

(a) The effects of fluctuations in the purchasing power of the currency and the net monetary position of a company;

(b) The additional charge to income for amortisation of non-monetary items acquired in prior periods;

(c) The interplay of interest income (expense) and general price loss (gain);

(d) The effect of income taxes based on the historical cost;

(e) The availability of profits in real terms for distribution purposes.

In price level restated financial statements emphasis has generally been directed to the income statement and reduced importance attached to the balance sheet. But the balance sheet deserves attention because anomalies arise in assessing the effects of price level changes on financial statements as indicated below:

(a) A material increase in the shareholders' equity of a manufacturing concern (caused for example by major restatements of fixed assets) is normally partially offset by curtailment of earnings arising from the increased depreciation expense calculated on restated fixed asset carrying amounts and by restatement of inventories consumed. Rates of return will be affected substantially. Conversely shareholders' equity position of a real estate or property owning company may show a favourable increase by reason of a restatement of properties which is not adversely affected by any significant increase in depreciation expense on those long life assets. A further factor which usually contributes to a favourable situation under conditions of price level restatement in this type of company is the general price level gain arising on a net monetary liability position resulting from the use of borrowed funds for the acquisition of fixed assets;

(b) Heavy borrowing may indicate that the company is in a state of illiquidity, yet the earnings for the year may appear unusually attractive to an investor because an excess of monetary liabilities over monetary assets results in the general price level gain in the income statement;

(c) Restatement of revenus (sales) alone often reveals that "growth" is not as great as was previously believed.

While accountants have explained the detail of preparing CPP accounts, analysts have already developed simple approaches for arriving at an approximate estimate for adjusting historical accounts to CPP. It may be that such a simple approach applied to the replacement cost concept might adequately combine the operating capability concept of capital maintenance with the effect of changes in general purchasing power. In any case it is suggested that the CPP accounts should indicate the amount of any gain on long term borrowed capital to emphasise the distinction between profitability and liquidity. They should also indicate the degree to which the value of materials and fixed assets have risen faster than is implied by a general price level correction to emphasise the difference between (a) measurement of profits; and (b) directors plans for the investment of that profit including the need for extra capital.

4. CURRENT VALUE ACCOUNTING - REPLACEMENT COST

It appears that CVA may be more appropriate in situations where an entity's capacity to move from one activity to another is limited, in the short term, because of manufacturing capacity in terms of factories, plant and machinery, inventories and management skill and experience in a particular industry. In these situations knowledge and use of replacement costs is an important factor in times of changing prices.

The exposure draft on current value accounting indicates (paragraph 6) that current value accounting may not adequately meet the situation of entities, the operations of which involve largely or predominantly, monetary assets or liabilities. It is believed that there is a need to determine those industries for which CVA may not be the most suitable.

Some of the initial thoughts on other entities for which CVA may not be the most appropriate:

. Entities substantially dependent on research to provide products for sale which are protected by licences, patents and trademarks, e.g. pharmaceutical and electronics businesses;

. Entities substantially dependent on exploration;

. Entities engaged in long term individual construction contracts;

. Non-profit organisations where the replacement of assets, especially buildings, and hence the continuity of the enterprise is dependent to some extent on government grants or donations.

After considering the entities for which replacement cost accounting may or may not be appropriate there is a need for an appraisal of the proposed method in the light of an appreciation of how individual businesses might be affected. Certain problem areas of valuation are set out below:

(i) Where an entity has a 'make' or 'buy' decision for inventory or fixed asset, which replacement cost is to be used?

(ii) Paragraph 51 (d) lists certain intangible assets under the heading depreciable assets to which replacement cost or net realisable value would apply but how does one determine the replacement cost of a patent, trade mark, etc. which has resulted from research and does the replacement cost necessarily assure the maintenance of operating capability?

(iii) Where an entity is engaged in natural resources what is the replacement cost of the ton of coal, iron ore or a barrel of oil? Does it include the related exploration cost? Does it affect the decision if an entity expenses or capitalises the exploration expenditure?

(iv) Does adjustment need to be made for replacement cost where plant and machinery is leased for substantially the whole of its economic life?

(v) How does one treat the intangible 'goodwill' for CVA purposes and does it matter whether it is recorded in the books of account or not?

(vi) Where an entity is engaged in specialised long term construction contracts how does one determine replacement cost and is it relevant?

(vii) What is the meaning of the replacement cost of an asset which it is not intended to replace but which is essential to the business?

(viii) Where is the information on replacement costs to come from, how much will it cost to collect, provide and use?

(ix) Is replacement cost capable of confirmation and who will confirm it?

The Securities and Exchange Commission in the United States has recently issued proposed amendments to regulation S-X to require disclosure of certain replacement cost data in notes to the financial statements.

In considering specific problems it is noted that the SEC often chooses to adopt historical cost rather than establishing a replacement cost which is either very difficult or does not have very much meaning.

There is also need to consider the alternatives mentioned in the exposure draft on CVA so that there is a consensus of opinion to support the accounting profession when it is determining a standard to be implemented:

(a) The treatment of monetary gains and losses;

(b) The treatment of holding gains;

(c) The question of a relative price adjustment, i.e. excluding the general purchasing power component. and

(d) Accounting for depreciation backlog.

A minor problem under CVA is that profits and losses from skilled or bad buying of inventories would be dealt with as holding rather than operating gains or losses.

Nevertheless a combination of the current value exposure draft and the concept of the dollar of current purchasing power as a unit of measurement may be an important step forward in issuing a standard which is necessary to avoid the uncertainty which exists at present. It is recognised that CVA probably serves the needs of more users than historical cost.

CURRENT VALUE

Notwithstanding the subjective nature of valuations it would be helpful for there to be a reconciliation of shareholders' equity from year to year distinguishing operating results, financing results and the relative effect of changes in asset values whether realised or unrealised. Certain organisations would be capable of this presentation now, e.g. unit trusts and many investment companies whether investing in shares or properties. The business community would benefit from investigating the problems associated with ascertaining values.

The biggest problem area seems to be associated with the valuation of intangibles whether recorded in the books or not, the adoption of the discovery method for accounting for natural resources and for those who have been involved in share valuations during the last 10 years or more, the effect of fluctuations in the stock market and a reluctance to say that because of stock market fluctuations and the consequent increase or decrease in the value of a company, directors have made greater or smaller profits during the period.

CONCLUSION

We could move now to the introduction of CPP accounting as a first step towards the acceptance in Australia, and internationally, of a satisfactory method of accounting in times of inflation. The introduction of CPP accounting as a supplement to historical cost would serve as a means of educating accountants and readers of accounts in the complexities of inflation accounting.

It is a minor modification to CPP to provide for additional amounts where replacement cost is higher than CPP adjusted amounts. A form of CVA will emerge in time, but the practical problems of implementing the CVA method proposed in the exposure draft, should be more fully researched.

It may be that CVA can only be introduced if a suitable method is recommended by a government committee of enquiry with particular responsibility for the implementation in practice, and accepted by the taxation authorities, the Stock Exchanges, the Corporate Affairs Commissioners and the accounting profession. The setting up of such an enquiry should be encouraged, once the UK Sandilands committee report has had wide circulation and comment.

In the absence of the widespread acceptance of CVA which such an Australian enquiry might bring about, the introduction of CVA may lead to the proliferation of valuations to suit directors' wishes; to resulting problems for readers of accounts and to further criticism of accounts and the profession by the CAC, the financial press and the public at large, whilst at the same time the maintenance of historical cost records will still be required for taxation purposes.