INFLATION AND ACCOUNTING
A REVIEW OF THE PRESENT POSITION IN AUSTRALIA
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..... The function of this introductory talk to members and guests of The Securities Institute of Australia is to give a neutral "overview" of the present situation as I see it before the other members of a panel present their views on particular aspects of the problem area commonly referred to as "Inflation Accounting".

May I say first of all that the views I express on this occasion are not necessarily those of the firm or professional bodies to which I belong. Although I am not called upon to put a personal view as to the best way out of the dilemna which confronts the business community on this issue, it may well be that because my analysis of the situation will be less than comprehensive, the manner of selection may reveal particular conclusions. I apologise for this but I trust that the strongly held views of some of those who follow will not be any less clear to you.

The situation today is one of great intellectual interest and of crucial concern at the practical level. You will not need to be reminded of the inflationary times we are living in, both in Australia and in other parts of the world. Whether or not you believe with Professor Milton Friedman that "inflation is a world-wide phenomenon but not an international phenomenon. That is to say, it occurs in many countries because all of those countries tend to follow roughly the same policies", (1) the fact that, whatever the causes, it exists on such a wide scale has forced accountants, businessmen and governments to face up to its consequences for business financial reporting.

With the degree of instability experienced in the Australian economy in 1974/75, with aggregate output declining for the first time in any financial year since 1952/53 and consumer prices rising by 17%, faster than in any year since 1951/52 (2), there has finally emerged a determination in Australia to consider alterations to the existing pattern of financial reports to take into account the effect of inflation, to supplement or replace conventional financial statements prepared on an historical cost basis.

The accounting profession in Australia, through the Australian Accounting Standards Committee - a "joint" Committee of the Australian Accounting Research Foundation (3), has issued two Preliminary Exposure Drafts (4), for consideration and comment by those interested in accounting practice, accountants and non-accountants. The Securities Institute of Australia is, I understand, to present the views of its members on those two exposure drafts and this panel discussion has been arranged to assist in the formulation of those views.

Before considering these two Drafts it should be mentioned that the Report of the Inflation Accounting Committee set up by the United Kingdom government in January 1974 under the Chairmanship of F.E.P. Sandilands, Esq., C.B.E. has just been presented to Parliament and it has recommended the adoption of a system of current value accounting (5). Further reference to this report and its recommendations will be made later; at this stage I would mention that the report did not recommend the system of supplementary CPP statements provided for in the U.K. Provisional Statement of Accounting Practice No. 7 on which the first Australian P.E.D. (CPP draft) was based. Its recommended system (CGA) is closer to the CVA system in the second Australian P.E.D. but not identical with it.

CPP METHOD

The CPP Method as set out in the preliminary exposure draft of December 1974 seeks to make allowance for the changes in the value of money, that is to say, for changes in the purchasing power of money over the period of time for which the accounts have been prepared and in respect of certain earlier transactions which lie outside the accounting period. It is "concerned with removing the distorting effects of changes in the general purchasing power of money on accounts prepared in accordance with established practice." (para. 11)

In general, but subject to an important exception, the method does not seek to deal with the relative values of non-monetary assets and to show in the balance sheet the assets at either replacement cost or current value (6). The method primarily endeavours to restate the accounts and balance sheet in the form of the historic cost accounts but with a correction for the monetary measuring rod. The main features of the method (paragraph 12) are:

(a) The keeping of records and basic annual accounts in historical dollars will be continued;

(b) There would be prepared for shareholders a supp-

(1) Milton Friedman in Australia 1975 - Constable & Bain and The Graduate Business School Club, Sydney 1975 P.59.

(2) Reserve Bank of Australia, Report and Financial Statements 30th June 1975, P.4.

(3) The foundation is supported by the two professional bodies, The Institute of Chartered Accountants in Australia and the Australian Society of Accountants.

(4) "A Method of 'Accounting for Changes in the Purchasing Power of Money' ", December 1974 and "A Method of 'Current Value Accounting' ", June 1975. For the sake of brevity the two drafts will be referred to as, respectively, the CPP and CVA drafts.

(5) Inflation Accounting. Report of the Inflation Accounting Committee, London, H.M.S.O., September 1975. (Recommends adoption of an accounting system to be known as "Current Cost Accounting"). Hereinafter referred to as the Sandilands Report and CCA system.

(6) An exception is in the recommended further tests in regard to certain current assets and fixed assets dealt with in para. 21 - see below.

lementary statement in terms of the value of the dollar at the end of the period;

(c) The figures in the basic accounts would be converted into figures in the supplementary statement by means of a general index of the purchasing power of the dollar;

(d) In a note to the supplementary statement there would be an explanation of the basis on which it had been prepared and comments on the significance of the figures.

A particular feature of the CPP system is the different treatment given to monetary and non-monetary items in the conversion of the figures from the basic historical cost accounts to the supplementary CPP statements. The monetary items are shown at their existing or contractual values and the loss which holders of monetary assets incur in terms of general purchasing power during a period of inflation are reflected. Similarly, the gain from having monetary liabilities during an accounting period is also taken into account; thus the system endeavours to provide for the adjustment for inflation of the values of non-monetary assets such as stock, plant and buildings, by the application of a general index, and the computation of gains and losses on monetary items to give a net gain or loss which is brought into account.

The index suggested by the exposure draft is the GDP implicit deflator and it is taken as being an indication of changes in the purchasing power of money. (The matter of the index to be used, and its application to paid-in capital, is an aspect regarding which comment is specifically invited by the AASC.)

It should be emphasized that the system does not seek to reflect current values but merely to make adjustments for the change in the dollar itself. The exception to this general position is the requirement in paragraph 21 that after converting certain current assets, one must apply to the resulting figures the test of "lower of cost (in CPP terms) and net realisable value", and that after restating fixed assets the test of "value to the business" should be applied and any necessary write-down made.

There is an interesting appendix, Appendix 1, to the exposure draft where comments are made on the relationship between current purchasing power adjustment and replacement cost accounting and in Appendix 2 there is an example of the presentation of supplementary CPP statements. Appendix 3 outlines the method of conversion and Appendix 4 contains the gross domestic product (GDP) implicit deflator index on the basis of yearly averages.

From a conceptual point of view (7), the CPP method may be classified as:

(a) in regard to capital maintenance concept: general purchasing power, and

(b) in regard to net asset valuation methods: historical costs, adjusted by general index.

The CPP method of adjustment is similar to that originally dealt with extensively by Sweeney in his book 'Stabilized Accounting', a classic work, (8).

To those who are interested in one man's struggle for recognition of pioneering work in this field I would commend to you the reading of: 'Forty Years After: or Stabilized Accounting Revisited' as contained in the reissue of this work. Sweeney, it might be mentioned, made an extended study of this subject in the 1920's and 30's paying particular attention to the experience of inflation and inflation accounting in France and Germany. In the U.S.A. the AICPA Study: Reporting the Financial Effects of Price Level Changes - Accounting Research Study No. 6 (1963) - substantially adopted Sweeney's methods, as did the more recent APB Statement No. 3 (1969) - "Financial Statements Restated for General Price Level Changes" and the FASB Exposure Draft (1974) - "Financial Reporting in Units of General Purchasing Power".

CVA METHOD

The second exposure draft "A Method of 'Current Value Accounting' ", adopts what it terms the "specific price change" approach which is concerned with changes in the prices of specific assets bringing these to account by revaluation of the particular assets" (para. 4b). An important feature is the treatment of the amount of revaluation as an adjustment to shareholders' equity; in the profit and loss statement the approach results in the cost of goods sold and depreciation for the period being based on average current values during the period or, alternatively, on current values at the end of the period" (para 4 (b)).

Looking at this suggested method from the point of view of the "Gynther Grid" it falls in the category of:

(a) capital maintenance idea: operating capacity;

(b) net asset valuation methods: current market buying prices (current replacement costs).

The essential CVA concept in relation to profit is that it is defined as "the amount available for distribution after having maintained intact the asset resources, both physical and monetary, which are needed to retain the existing potential of the entity for providing goods and/or services" (para 9 (c)). The notions of overall capability for providing goods and services and continuity of operations of the entity are basic to the approach contained in this exposure draft.

Some key features of CVA are:

(a) the taking up of periodic revaluations to reveal changes in the value of non-monetary assets such as inventories and fixed assets which are

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(7) A useful device for identification of alternative systems is the grid used by Professor Reg S. Gynther in his article "Accounting for Changing Prices : Some Recent Thinking, Recommendations and Practice", The Chartered Accountant in Australia, December 1971;
I have made use of this grid in an article : "Current Value Accounting and Price Level Restatements, Where do we stand?", The Chartered Accountant in Australia, September 1973.

(8) Henry W. Sweeney "Stabilized Accounting", originally published in 1936; re-issued in 1964 by Holt, Rinehart and Winston, New York.

essential to operations i.e. the treatment of so-called holding gains and holding losses. Holding gains are not regarded as part of profit because their distribution would run down the operating capability of the business (para. 21) and "conversely, there is no need to make good any of the so-called holding losses, since the operating capability of the business is, in fact unchanged", "Non-monetary assets which are not essential to operations would be valued at net realisable value" and for these gains or losses it would be correct to treat them as part of the profit or loss for the period.

(b) The important aspect of gains or losses from monetary items receives comment (paras. 22 to 25) but the conclusion is reached that (para. 25) "the subject of gains or losses on monetary items needs further study, before any firm recommendation can be made in relation thereto".

(c) An area of particular interest is the treatment of costs as expressed in 'average for period replacement cost' for cost of goods sold, and the depreciation charge for the period also expressed in terms of 'average for period replacement cost' of the assets to which the charge relates.

(d) The treatment of the 'depreciation gap' or 'backlog depreciation' is discussed (para. 29) and the recommendation is made that the most appropriate allocation of such is to charge it against retained earnings so as to avoid the adjustment being a charge against the profits for the period (para. 33).

(e) It is suggested that the accounting records themselves be adjusted by direct entries (para. 34) and that showing historical cost figures as well as the current cost figures in the financial statement is superfluous, it being stated (para. 37) that "dual measurement presentation has to be rejected as a practical solution, except possibly as a transitional procedure for a brief period."

(f) It is recommended that in addition to the current value balance sheet and current value profit and loss statement there should be presented a statement in change of shareholders' equity, reconciling the amount of shareholders' equity at the beginning and the end of the period (para. 56). In the example given in Appendix 3 it will be seen that the movements in shareholders' equity include the fixed asset revaluation movement of a capital nature in the Revaluation Reserve and operating profit (CV) and backlog depreciation in the retained earnings. The aggregate of the movements in the three accounts - Capital, Revaluation Reserve and Retained Earnings - represents the combination of contributed capital, capital value restatements and operating profits to date, less dividends paid.

Generally, this CVA system is a replacement cost system, somewhat similar to that used in a number of large Dutch concerns. However, it is non-committal in respect of the treatment of monetary gains and losses.

Appendix 1 contains a listing of monetary and non-monetary items.

Appendix 2 an illustration of the calculation of cost of goods sold.

Appendix 3 an example of the application of CV accounting.

SANDILANDS REPORT

Reference was made earlier to this report and its recommendation that a Current Cost Accounting System should be used. This recommendation is of particular interest to us in Australia; the document itself is of considerable value, containing as it does an extended discussion in some 364 pages and treating both theoretical and, to an extent, practical issues. A summary of recommendations taken from para. 519 of the report is as follows:-

(i) All companies should as soon as practicable adopt an accounting system to be known as 'Current Cost Accounting' the main features of which are:

(a) Money is the unit of measurement;

(b) Assets and liabilities are shown in the balance sheet at a valuation;

(c) 'Operating profit' is struck after charging the 'value to the business' of assets consumed during the period, thus excluding holding gains from profit and showing them separately.

(ii) Current cost accounts should as soon as practicable become the basic published accounts of companies. However, the net book value of assets on a historic cost basis and historic cost depreciation should continue to be shown in notes to the accounts.

(iii) Companies should include a funds statement with their accounts, and directors of all companies should be required in future to include in their annual reports a statement of the adequacy of the cash resources likely to become available to meet the company's requirements in the ensuing year.

(iv) It is not recommended that CPP supplementary statements should be attached to current cost accounts.

(v) A Steering Group should be set up to oversee the introduction of Current Cost Accounting. A Statement of Standard Accounting Practice should be issued as soon as possible requiring listed companies, large unlisted companies and nationalised industries to follow an initial standard of Current Cost Accounting at the earliest practicable date. It should be made mandatory for such companies to adopt Current Cost Accounting for accounting periods beginning not later than 24 December 1977, if this proves feasible.

From the above it will be seen that the significance for local purposes is that the CPP method has been put aside in favour of a current value approach, the particular approach being in some respects similar to that of the CVA exposure draft.

SOME POINTS RAISED BY CRITICS

Having briefly considered the two systems, let me indicate some points of difference between the proposals and some criticisms made:

1. CPP is an adjusted cost system and depends on the notion of adjusting for general change in the value of money the dollars which are used to measure capital and profit, but it does not seek to alter the basic notion of the capital maintenance or profit from that used by historical cost accounting; therefore it retains many of the advantages and disadvantages of such a system.

2. In isolating certain aspects of the monetary gain or loss CPP is sometimes criticised on the grounds that it does not take into account properly the expense factors which may be attributable to the monetary gain or loss, such as interest and other costs of borrowing, and could cause the monetary gain aspects of the over-emphasized, hidden costs of possible future disequilibrium not being revealed. An illustration of this factor is to be found in the results of applying CPP restatement to the highly geared companies such as financiers and developers, as compared with the less highly geared manufacturing companies. Some surveys of this type are already available in the literature.

3. The adjustments which are called for in the draft to reduce the CPP adjusted figures to current market values in some cases are cited as being a departure from principle even under the CPP method.

4. Some critics have stated that the CPP method does not indicate effects of inflation and that these effects cannot be indicated by simple monetary calculations of the type proposed in the method.

5. Whilst the CPP method has the advantage of simplicity in terms of the clerical operation, it has been stated by some critics that the significance of the adjusted figures for profit, net worth, etc. is not much more than for the unadjusted figures.

6. Some critics have considered the notion of dollars of particular vintages too complex a notion for laymen to grasp so that the conversion of dollar figures for an earlier period to dollars of a later period is a cause of confusion.

7. For some people the notion of an index which represents changes in the general purchasing power of the dollar is too nebulous and unquantifiable a concept. For example, it is claimed that the broad concept is so vague as to be meaningless for most users. The GDP implicit deflator is subject to adjustment and represents a very wide range of product. Distortions can occur as for example in the recent year in regard to the distorting effect of the drop in price of farm produce. If, on the other hand, one reverts to the CPI (consumer price index) as a means of adjustment, one is then limited to the price changes that have occurred in a particular basket of commodities which would be typical of the selection made by a possibly untypical family. In other words it is claimed that an index adjustment is, in itself, an average of a particular type regarding which one may have reservations as to its representativeness. Some critics would maintain that it is impossible to quantify the notion of "the value of money in general" in a community. (I think this would be close to the position taken by the Sandilands Committee).

8. Perhaps the most serious area of criticism is in relation to the usefullness of the resulting CPP figures. How do these figures compare in a qualitative sense with the results of other systems in satisfying the needs of users? This is the vital test.

Turning now to the discussion of CVA method, some of the criticisms made of this are as follows:

1. The notion of operating capacity is itself a vague one and could vary from business to business to such a degree that inter-firm comparisons of results could be quite misleading when considering alternative investment opportunities. Question arise as to exactly what is being maintained in an operating capacity concept. Is it the value of goods produced? Is it the number of goods produced? Is it the physical capacity of the plant? How is this concept related to companies such as financial institutions where most of the assets are of a monetary nature?

2. The notion of holding gains and losses not being taken into account in profits has also received criticism. Is there a clear line of demarcation between an operating gain and a holding gain? In a sophisticated community there can be many motives involved in the purchase of fixed assets, for example. The procedure of allocating profits or losses from holding raw materials to the revaluation reserve would be held by some to be an unnecessary division or at least an unreal division of the gain. This would, of course, be more apparent in some types of industry where there is a strong speculative element in the acquisition of materials and the carrying of stocks.

3. Some critics would state that the absence of any adjustment for general price changes (apart from the treatment of specific price changes) is a definite lack in the CVA basis as contained in this draft. The separation of "real" as distinct from "fictional" gains by the use of a general inflation index is of importance in the eyes of some.

4. One school of thought would have a monetary gain or loss calculated in conjunction with CVA figures. The exposure draft is, of course, silent on this issue and leaves it as a matter for subsequent determination. On the other hand the Sandilands committee have come out and stated that they see no good purpose being served by such an adjustment.

5. Replacement cost, as a basis of asset valuation, is seen as being subject to many difficulties by some. Some would prefer exit values or net realisable values as a uniform basis rather than the more limited resort to them indicated in the draft.

The points listed above are mentioned only as an indication of the type of discussion which has gone on. Obviously a more systematic treatment is desirable and

I would draw your attention to the existence of an evaluative paper entitled "A Comparison of Accounting Measurement Systems" produced under the auspices of the Australian Accounting Research Committee, another committee of the Australian Accounting Research Foundation. This paper is an attempt to assist all those who are interested in this particular subject area in evaluating the alternative systems which have been proposed. I would commend its use to the members of your Institute to assist them in assessing the relative merits of any suggestions made in the area of alternative systems. Originally prepared by Mr. Chris Warrell of the University of Melbourne, it has undergone some change under the adaptations and editing of the Research Committee. I would particularly commend to you the study of Parts 111 and 1V of this paper, including the numerical comparisons shown in the last few pages of this paper of the results using the different systems on the same body of data. Included is the result of applying the CPP exposure draft and the CVA exposure draft, an "exit value" system somewhat akin to that proposed by Professor Chambers who is contributing to this panel discussion and an "entry value" or "relative price change" system. All of these are compared with the historical cost accounting figures which would be shown under conventional procedures.

In conclusion, may I mention the following points:

1. At this stage the exposure drafts in the Australian setting are preliminary exposure drafts only and your comments, and the comments of all who are interested, on both exposure drafts would be welcomed. The fact that there are only two exposure drafts should not prohibit the expression of views as to alternative arrangements which may be considered desirable.

2. In considering both the exposure drafts put before you, and your own suggestions as to improvements or alternatives, I would remind you to consider both what is theoretically desirable and the practicality of carrying out the suggestions. Also it is most important that the very wide range of public and private businesses be considered - it must include for instance, manufacturing organisations, financial institutions, wholesalers, retailers, high-geared companies, low-geared companies; large companies and small businesses both incorporated and unincorporated.

I trust that I have helped to set the scene for the discussion that will follow.

S. A. I. NEWS

N.S.W. COUNCIL

The Divisonal Council regrets the resignation of Mr. D.I. Thorpe but welcomes Mr. J.H. Graham, a partner in Freehill Hollingdale and Page.

GOVERNOR GENERAL AND GOVERNOR OF N.S.W.

The Federal President and the N.S.W. President recently visited His Excellency the Governor General and His Excellency the Governor of N.S.W. with a view to explaining the Institutes' aims and objectives. The meeting culminated in an offer by the Governor General to speak at any Institute Functions which might be held in the future.

S.I.A. SUBMISSION TO GOVERNMENT - CORPORATIONS & SECURITIES INDUSTRY BILL 1975

On Friday, October 10, 1975, Mr. J.G. Morris (N.S.W. President) and Mr. M.R. Powditch (N.S.W. Councillor) attended a session of the Senate Select Committee, and answered many questions relating to the Institute's submission posed to them by Senators Georges, Wright, Durack and Walsh. Senator Georges (Chairman) thanked Mr. Morris for the Institute's submission and confirmed that the suggestions would be well considered by the Committee.

NEW MEMBERS & FELLOWS

NEW SOUTH WALES

Fellows - B.A. Leighton-Morris; B.M. Dixon; S.C. Hordern; J.M. Troy.

Provisional Associates :
S.F. Higgs;
N.G.H. Pilcher;
M.J. Linklater.

VICTORIA

Fellow - R.G. McCrossin

Provisional Associate :
R.A.A. Anderson

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