CCA – A RESPONSE FROM THE MARKET PLACE

The Institute has followed with interest the steps being taken by the accounting profession to improve accounting methods.

On behalf of the Securities Institute I have written to the Institute of Chartered Accountants and the Australian Society of Accountants offering our services to the Steering Group which has been established to assist the introduction of C.C.A. We believe that as "users" of published accounts we should be given the opportunity to put our point of view when changes are contemplated.

A Committee comprising Messrs. M.F. Desmarchelier (Director of Administration, Hungerfords), L.L. Hall (N.S.W. Investment Manager, A.M.P. Society) and R.B. Willing (Investment Manager, N.R.M.A.) appraised the earlier exposure drafts and their comments were published in previous issues of JASSA. They have made a preliminary evaluation of the Provisional Accounting Standard "Current Cost Accounting". The tone of their comments in this initial response is critical, and it would seem that much care will need to be taken in the interpretation of C.C.A. accounts. In addition, as C.C.A. does not apply to monetary items, the accounts of companies in the financial sector will not take account of inflation.

Members' views on the subject would be appreciated by the Desmarchelier Committee and the Editor of JASSA.

A.H. Urquhart
Federal President

INTRODUCTION

We have written this initial response to the Statement of Provisional Accounting Standards – "Current Cost Accounting" viewed from a position as members of The Securities Institute of Australia. We seek to reflect the response of users of financial reports: businessmen, investors, analysts and, as such, have avoided comment on the technical aspects of the pronouncement. We welcome the prospect of change which leads to an improvement in financial reporting. We wish to support constructively the evolution of better accounting and believe that it would be useful to further refine some of the procedures outlined in the provisional statement. It will be a pity if unreasonable attacks are made on the new statement by those directors who cannot fully comprehend it (or do not wish to understand it). Similarly, we should be on the alert for those managers who will attack the system because their performance in inflationary times will be shown to be less competent.

SUMMARY

The article outlines some of the reservations we have about CCA as a method of accounting and we have indicated some of the implications of CCA for corporations and investors.

Users should not believe that CCA accounts necessarily give "true" or "real" results. As with historic accounts, the outcome is dependent upon the definition of the system. CCA balance sheets are not intended as valuation statements.

Maintenance of physical capacity is highlighted but financial capacity is largely ignored.

We cannot say whether the share market has fully recognised the implications of CCA. The published results of companies with sizeable stock and depreciable plant will be very different to before. Traditional investor attitudes to various ratios and yields will need to be altered.

Capital raisings may be more difficult for some companies.

We suspect that many advocates of CCA will only remain in favour while there is the possibility of influencing favourable taxation changes. If the tax burden is reduced for some it will be interesting to note the attitude of the remaining taxpayers who presumably will have to take up the shortfall.

CCA could benefit the cash flows of some businesses by changes in tax paid, lower dividend payouts and the ability to demonstrate a need for higher selling prices. Such a re-distribution of income may cause an adverse reaction from other sections of the community.

Some Aspects of CCA

The continuing entity notion is an implicit part of CCA, Directors and management will present accounts which reflect the position which would have occurred had fresh investment decisions for plant replacement been made. They will do so without regard to the financing of the replacements. The proprietors are to be presented with reports showing the effects of investment decisions which have not been made and which proprietors may not consent to make.

CCA balance sheets do not show the actual financial position of an entity, the means at its disposal, its capacity to effect change either through its existing resources or through its potential ability to raise finance by borrowing or equity.

It appears that under CCA, an entity is unable to reflect a profit in its accounts from the holding of non-depreciable, non-current assets. We note that the provisions of 3.11 state clearly that the difference between the selling price and the carrying cost of assets other than inventories is to be brought to account in the profit and loss account. However, non-monetary assets are to be stated in each report at either their market value, their value in use or their current cost or recoverable amount, and differences between these values and original cost are to be passed to current cost adjustment account

(CCAA). It therefore seems to follow that if there is a surplus arising between the original cost and final sale of a non-inventory asset, only that part of the surplus arising between last balance date and date of sale goes to profits. Distributions to shareholders may be made from CCAA, but only if reserves etc. exceed any CCAA debit (13.36) and, also, if the distribution is identified as affecting a reduction in the entity's operating capability (13.37). If this reasoning is correct, implementation will have a disastrous effect upon all investors, including those in land and property.

We believe there is an inconsistency between 4.06, which states that comparative amounts in CCA should be corresponding items without any re-statement for subsequent price changes and the philosophy expressed in 12.10 and 12.13 that a CCA balance sheet constitutes a link between successive profit and loss accounts in consistent, compatible terms.

We note the deferral of a method dealing with monetary items (12.22/25) and are aware not only of the overall problem but, in particular, the problem of choosing an appropriate measurement of change in general purchasing power. Nonetheless, we find it difficult to accept a concept implicit in CCA of maintenance of profit, capital and operational capability which, though it pays considerable regard to physical capacity, ignores a major component of financial capacity. Financial organisations can be as adversely affected by inflation as commercial and manufacturing enterprises, although the effects are masked by conventional accounting.

Corporations

If the CCA method is adopted only in Australia, the resultant decline in reported profits of many groups may impair the capacity of local companies, when compared with overseas investors, to raise funds for Australian development.

CCA goes little or no way towards forming an effective basis of reporting for Australian groups engaged in activities such as farming, grazing, mining, banking, life assurance, general insurance, investing, and superannuation. The future allocation of resources in the capital market might well differ as between those entities for whom CCA applies and the others. We are not aware of empirical evidence arising from field testing of CCA amongst an appropriately representative range of industries and services. However, from our knowledge and experience, from industry surveys and published financial reports we can surmise that a great deal of social and economic problems could arise from a harsh or, perhaps, unthinking application of CCA in industries where venture capital has been expended on infrastructure and large scale capital works. Without limiting the generality of that comment, many groups engaged in primary, extractive, pastoral, chemical and metallurgical industries could be significantly affected.

We are concerned that unless the Australian Government fully supports all the concepts then many companies, particularly those utilising plant and machinery, or holding inventories, will report lowered profits without a commensurate fall in taxation. On the other hand, if the authorities allow a reduction in the amount of taxation payable by some companies, those companies will have a benefit relative to other taxpayers who presumably will have to make up the revenue foregone. This may lead to opposition from wage earners.

Debenture trust deeds will need to be re-written and presumably different standards will apply according to the effect CCA has on the particular company.

CCA profit and loss statements exclude holding gains from "good buy" situations (12.26/27) and thus inhibit the entrepreneurial profit incentive; this incentive is fundamental to a healthy investment market.

In times of rising prices, CCA will strongly encourage businesses to lease rather than to buy depreciable assets unless taxation considerations become more advantageous in future. We are at this stage uncertain as to how finance companies as lessors would show the leased equipment in their accounts, but we believe it likely that such transactions will be treated as financial ones and so avoid current cost depreciation charges. Some companies could establish a finance company as a subsidiary to provide in-house leasing without the embarrassment of higher charges in the revenue statement.

It would seem under 3.04 (b) that where it cannot be expected that current costs (actual or written down) will be recovered in full, then the value to be shown is the net present value of future utilisation, leading to a constant future zero profit/loss situation, after adjusting for interest. Many companies in capital intensive industries must be in this situation at present.

The situation of those proprietors who make effective use of written down equipment is interesting. Under CCA they will probably have to show a cost of production similar to a producer using more expensive equipment. One could envisage companies, using plant which has been fully depreciated under historical cost accounting, who would be tempted to mislay those pages in their plant register itemising the written off equipment. Conversely, given the inherent subjectivity, dishonest or misguided directors are given an opportunity to significantly inflate the apparent asset base of a corporation, albeit at the expense of future profitability.

It will be even more important now for companies to give more adequate disclosure. To allow shareholders to have an understanding of the real situation in a company it will be necessary for the company to indicate such matters as the general condition of plant, the likely cost of re-equipping and some indication of the level of physical operations. This information is required because under CCA companies having new plant will show a profit similar to that of a company using written down plant.

Investors

Shareholders will need to be re-educated. Existing P.E.'s, dividend covers, interest covers, etc. will no longer apply. Followers of the efficient market hypothesis hold that the market has already taken into account the effects of inflation on individual companies. However, those companies which will be restrained under CCA from continuing to pay dividends will certainly suffer a fall in market price. Non payment of dividends would lead, in the absence of a better profit performance, to calls for voluntary liquidation and return of capital, or otherwise attract asset stripping predators. During the changeover period the confusion in many shareholders' minds will lead to uncertainty in the market-place.

Shareholders will naturally expect dividends to be maintained wherever possible because companies reporting under CCA should have relatively less need for retained profits.

Many corporations will need to show details of actual and projected cash flows, in some cases for many years, in order to obtain institutional support for proposed borrowings. The evaluation of a proposed capital intensive project at a time when inflation is expected to continue could well show an acceptable discounted cash flow rate of return but also indicate CCA losses (or nil profit) in all future years.

Conclusion

We are conscious that the accounting bodies have examined many submissions and have considered many points of view. Some may feel it is unfair of us to be critical of aspects of CCA in this response. But, in the ultimate, a decision whether a company is to be formed or is to grow will be made in the capital market. CCA, as it stands, will, for many, inhibit this formation and growth. It will also disappoint those who have looked forward to a solution to the problems of accounting for inflation.

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