INFLATION AND ACCOUNTING

The Institute has made the following submission to the Australian Accounting Research Foundation:-

**Comments on the Preliminary Exposure Drafts:
A Method of Accounting for Changes in
the Purchasing Power of Money
A Method of Current Value Accounting**

1. CONCLUSION

The members of the Securities Institute have not arrived at a unanimous recommendation. However, it is felt that neither of the two exposure drafts is entirely suitable. It is strongly recommended that the profession prepare another exposure draft which attempts to account for more of the effects of inflation.

The prime objection to the C.P.P. method is that it is based on the making of certain arithmetic adjustments to historic accounts which themselves have serious shortcomings.

The C.V.A. draft does not deal with inflation as such while the C.P.P. one does. The method relies on the presumption that assets will be replaced. We believe that shareholders and other users of accounts are less interested in the maintenance of the physical capacity of the company, and are more interested in the maintaining of the real value of the shareholders' equity.

We believe that it is necessary for the users of accounts to be given a balance sheet which indicates a realistic position and for the income in the profit and loss account to be the real income after inflation is taken into account. That income should be dissected to indicate clearly that part which is the operating profit of the enterprise. Such information would allow evaluation of the past performance of management and provide a base from which to predict the entity's prospects.

2. ACTION TAKEN BY THE SECURITIES INSTITUTE OF AUSTRALIA

A sub-committee comprising M.F. Desmarchelier, L.L. Hall and R. Willing was established during the year. A number of discussion papers was published in the Securities Institute Journal JASSA and a number of meetings of members was held.

One of the difficulties in attempting to achieve a unanimous viewpoint from members of the Institute was that many members held the pragmatic belief that it was of paramount importance to do something immediately to assist the liquidity and even survival of businesses. This meant that many members as a first step were prepared to forego the attempt of achieving a more perfect method of accounting in favour of implementing any system which would have taxation advantages and which perhaps might allow for a better hearing from the P.J.T.

3. THE SUB-COMMITTEE'S REPORT

Attached is an article written by the sub-committee which is based on papers that they have published in JASSA. The paper is a critical one which outlines the shortcomings from a users point of view of both the C.P.P. and C.V.A. proposals. In addition it also critically examines Chambers Continuously Contemporary Accounting Proposal.

Also enclosed is a copy of a comment (prepared by the sub-committee) from the special inflation accounting issue of JASSA which outlines the spread of views that members hold.

4. FUTURE ACTION

Even though the comment deadline will soon be passed it is the intention of the Institute to undertake further work on this topic. It is hoped that our members will be able to come forward with a more positive approach to the subject.

On behalf of the Securities Institute of Australia
A.H. Urquhart
Federal President

The article prepared by the sub-committee which was attached to the submission was largely based on the articles in JASSA:—

An examination of the C.P.P. Method — May/June, 1975

An examination of Replacement Cost — July/August, 1975

The article also included a discussion of Professor Chambers' Continuously Contemporary Accounting which is set out below. Also attached to the Institute's submission was the page from the last issue of JASSA which itemised the wide range of views that analysts have expressed.

CHAMBER'S CONTINUOUSLY CONTEMPORARY ACCOUNTING

We are attracted by certain aspects of this method. In particular, we like assets to be valued at net realisable prices in the normal course of business (not at forced sale price). Accounting for inflation by showing the amount required to maintain the purchasing power of shareholder's equity seems a sound approach which has the great benefit of being simple to implement and which would be easily understood by users of accounts. In coping with more realistic valuations and the accounting for inflation the method combines the two tasks which need to be tackled.

When comparing the position at the beginning and end of a period it would be desirable to have both sets of figures in terms of the same purchasing power. However, this would entail considerable effort and would necessitate restatement of the opening figures. As our prime interest is in the comparison of the change in net worth during the period, a practical solution is to apply a suitable index to the opening net worth (capital maintenance adjustment).

As accounts are primarily prepared for the owners of an enterprise, it seems appropriate before determining the surplus, to provide for the maintenance of its net wealth in units of comparable purchasing power by the transfer to a capital maintenance account of an amount calculated by using an appropriate index to show the change in purchasing power of the net wealth at the commencement of the period. Maintenance of physical capacity is a separate issue to the "well-offness" of the owners.

It should not be thought that the use of current values will make the balance sheet the final arbiter of market value. Users will apply a premium or discount to the net position shown according to their estimation of the enterprise's prospects in the light of such other information as its particular industry, competitive position and management.

PROBLEMS WITH C.C.A.

There is much criticism of the use of current or realisable values, based often upon the alleged difficulty in ascertaining those values. It is claimed that there is too much subjectivity which provides scope for deception, fraudulent or otherwise. However, current values need to be ascertained under the C.P.P. method. In using R.C.A. as proposed in the C.V.A. draft, realisable values are to be preferred when there is doubt regarding the replacement values.

Under C.C.A., income for a period is the change in the owner's net worth (in real terms following the capital maintenance adjustment). Users will require 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

Such an approach is not expressly recommended in the exposure draft and it is not clear whether it would be done. It is especially important to indicate (if possible) the "normal operating income", because this is a key statistic in the evaluation of management.

The importance of being able to split the change in net worth is highlighted in the cases where wide fluctuations in asset valuations occur. Such changes could obscure the underlying operating profitability of the enterprise.

Depreciation, as such, is not charged. In many instances the equivalent of the depreciation charge, the change in the value of the plant, will be uneven over the life of the plant. The charge could well be very high in the early years. Sometimes, of course, there will be an addition to income when plant values increase.

The above could cause some enterprises to be concerned with the cosmetic effect on income of new investment. Desirable investment from a medium/long term aspect could be deferred to avoid adversely affecting short term profits.

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 is a strong argument that the liabilities should 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 the financial specialist to divest himself of the liability. The amount could therefore be higher or lower than the face value of the liability.

The difference in real net worth after accounting for changes in the purchasing power of the currency would be an equitable basis for taxation. Taxable profit, therefore, would not include general inflationary gains. Only enterprises holding assets which appreciated at a faster rate than inflation would be taxed on that surplus. However, those managers whose enterprises might enjoy such "real capital gains" would probably object. In general, businessmen will support that system which appears to entail the least tax impost.

A COMPROMISE

The main problems with C.C.A. appear to be that of valuation and of income detail.

We would advocate use of "fair values" – for example, those values which would be used in the valuation of an enterprise undergoing a merger. Such values would detract from the purity of the author's concept, but would probably cause less adverse impact on management's new investment intentions. The concept of fair value appears to be well documented in U.S. literature.

It will be necessary to highlight that portion of income which is ordinary operating income.

MEMBERS COMMENTS ARE STILL REQUIRED

As set out in the submission it is the Institute's intention to attempt to have members formulate a more positive approach to the subject. In the near future the sub-committee will hold further meetings to allow members to put their views forward.