

CURRENT COST ACCOUNTING — AN INVESTOR'S VIEWPOINT

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(Mr. Holst has been appointed the Official Representative of The Securities Institute of Australia to the C.C.A. Steering Group established by the Australian Society of Accountants and The Institute of Chartered Accountants in Australia. The views as expressed in this article are those of the author as The Securities Institute is yet to form a consensus on this matter.)

On the one hand companies are reporting increasing profits, on the other they are going deeper into debt to buy plant and stock not for expansion but merely to replace the plant and stock that have been used. When we consider company accounts prepared on the basis of historical cost this is not immediately apparent. Yet investors generally appreciate what underlies the accounts and appreciate the problems that companies face. This ability of investors to see beyond the figures in the accounts is not new. What is more, investors will continue to look beyond the published accounts when companies report on the basis of Current Cost Accounting. When contemplating how investors will react to the introduction of CCA it is most important to bear this in mind.

Published accounts now are being put to uses for which they were not designed. Published accounts were once a report from management to shareholders. Now it is in reality a report to the world. These published accounts form the basis for many decisions, in particular they are the basic data for the community as a whole to assess a company's ability to pay taxes, and to pay increased wages, and to assess the company's ability to absorb increased costs. It is because historical cost accounts, particularly statements of profit, may be misleading for these purposes that it is necessary we find a new method of accounting.

Bearing in mind that various users of published accounts will have differing requirements, and that the circumstances of different companies may be vastly different, it seems to me that no one method of accounting can possibly meet the requirements of every viewpoint. The best we can hope for is a reasonable compromise, where as much relevant information as possible is presented clearly and consistently. Each user of the published accounts can then use the material in the way appropriate to his purpose. We are all familiar with the characteristics of financial reports presented on the basis of historical cost and can interpret them. We must now learn the characteristics of financial reports presented on the basis of current cost accounting and learn to interpret them.

There is still controversy about Current Cost Accounting, and the final form adopted may differ from the Provisional Standard.

Profits — The General Picture

In broad terms, the operational features of CCA are summarised as follows:

- (a) The result for any one period of accounting is determined by matching the revenue for the period with the current cost of producing that revenue. To this end, the cost of goods sold is calculated (or adjusted) to reflect the current cost of goods when consumed. Similarly, depreciation charges are calculated (or adjusted) to reflect the current cost of the service potential of depreciable assets consumed or expired in the period. No adjustment is normally required in respect of any other costs brought to account as expenses for the period because such costs are already expressed in terms of the current prices of the goods or services to which they relate.
- (b) In the balance sheet, the resources of the entity are stated, where applicable, on the basis of their current costs at balance date.

Using Current Cost Accounting as set out in the Provisional Standard most companies will report substantially lower profits.

GUESSTIMATE OF AUSTRALIAN INCOME AND TAXATION**NON-FINANCE COMPANIES —
Sm Year Ended 30 June**

	1976*	1977 ⁺	1978
- Aust. Economic Review - - estimate CCA figures -			
Hist. Cost Income	5,903	6,715	8,058
<u>less:</u> Inventory			
Appreciation	1,927	1,950	2,180
<u>less:</u> Extra			
Depreciation	1,672	1,800	2,340
	<u>2,304</u>	<u>3,750</u>	<u>4,520</u>

Current Income	2,304	2,965	3,538
less: Tax	2,690	2,300	2,300
Current Income	(386)	665	1,238

* Based on The Australian Economic Review 3rd Quarter 1976.

+ Based on The Australian Economic Review 3rd Quarter 1976 with extra depreciation reduced from \$2,397m to \$1,800m (see text below).

The Table on the left above was derived from statistics published in The Australian Economic Review 3rd Quarter 1976. It shows the position of all non-finance companies in Australia in 1975/76. It includes adjustments for inventory appreciation and extra depreciation. The table shows that after providing for income tax the total profit in 1975/76 after such adjustments is estimated to be a loss of \$386m.

While the Australian Economic Review estimates of inventory appreciation can be regarded as a good guide to likely similar adjustment to be made on adopting CCA, their estimates of extra depreciation are almost certainly higher than the adjustments that would be made if CCA were used.

Consider first the stock value adjustment (or cost of goods sold adjustment). When considering the totality of all companies we can regard the magnitude of this adjustment as proportional to the rate of inflation. To the extent that the rate of inflation in 1977/78 falls below the 13%-14% rate prevailing in 1975/76, so will this adjustment fall.

Next consider the additional depreciation adjustment. The method used in the Australian Economic Review to calculate this adjustment is not the same as the method proposed for Current Cost Accounting. The Australian Economic Review figures are calculated by applying an appropriate price index to the historical cost of existing plant and adjusting the depreciation accordingly.

In Current Cost Accounting the value of plant is defined as the written-down current cost of obtaining, in the cheapest possible way, the same service potential (with provision for a reduction to the recoverable amount if that is lower).

On the introduction of Current Cost Accounting companies will do two things which will lead to lower depreciation charges than those implied by the Australian Economic Review figures. Firstly, technological developments and economies of scale often provide cheaper alternatives than a simple reproduction of existing units of plant. For example it may be cheaper to replace ten existing units by

two much larger units and thus reduce the capital cost per unit output. Under Current Cost Accounting the current cost of the service potential of these ten units should be based on the cost of the two modern units rather than the cost of reproducing the ten old units. Secondly, with the introduction of Current Cost Accounting companies will take the opportunity to reassess the economic life of their plant and machinery and many will find that it is appropriate to depreciate these assets over a longer period than originally selected.

When discussing the cost of goods sold adjustment we looked at the effect of changes in the rate of inflation. When considering depreciation the position is more complicated. If inflation stopped today it would be many years before depreciation charged under Current Cost Accounting would become the same as that charged under Historical Cost Accounting. In fact a difference would persist until the last piece of equipment acquired at less than the stable level of prices was finally scrapped. This is because the difference between current cost and historical cost is related to the cumulative inflation from the date of acquisition of the asset to the period of reporting.

The final matter to consider that may moderate the impact of Current Cost Accounting on stated profits is the adoption by the Government of the taxation reforms advocated by the Mathews Committee. The partial introduction of the stock value adjustment in respect of the year 1976/77 will reduce company tax by approximately \$350m. It is reasonable to look forward to further implementation of the Mathews Committee recommendations in 1977/78.

To arrive at the estimate for 1977/78 I have assumed a 20% growth of Historical Cost Income. To estimate the inventory and depreciation adjustments I have assumed an unchanged rate of inflation and the same physical level of stock and plant. To estimate Income Tax I have assumed unchanged rates of company tax and 100% deduction of Stock Valuation Adjustment, but no deduction for adjusted depreciation.

The projected figures for the year to 30 June 1978 should be regarded as no more than a plausible guess. On this uncertain basis I estimate the CCA Net Profit after tax in 1977/78 would be about 40% of the \$3,212m historical cost net profit recorded for non-finance companies in 1975/76.

Dividends

Distributions are subject to legal constraints in accordance with existing statutes and common law. These will continue as before.

It is clearly contemplated in the Explanatory Statement issued with the Provisional Standard that

CCA profit will "provide a more realistic basis for determining dividend policy".

This has two aspects. First it implies that it would be quite appropriate for a company to distribute all of its profit measured by CCA, since this profit is struck after deducting all charges necessary to maintain its operating capability. Second it states that any distributions out of a credit balance in the current cost adjustment account (the account that is credited when plant and stock is written up to current cost) must be distinguished from distributions of CCA profits, and should be disclosed in the financial statements, with emphasis on the fact that the distribution was made in consequence of a decision to reduce the entity's operating capability.

In 1975/76 the non-finance companies paid dividends of \$1,025m out of historical profits of \$3,212m. If companies have a CCA profit of \$1,238m in 1977/78 dividends might well be maintained overall. Individual companies, of course, might be forced to pay dividends out of reserves or to reduce dividends.

However, if companies are faced with the problem they may well be able to pay dividends out of reserves for a few years as they have been able to do in the past when things were tough.

Purchasing Power Gains and Losses on Monetary Items

The Explanatory Statement discusses this issue in the following way:

"Changes in the general level of prices (inflation or deflation), with corresponding changes in the general purchasing power of money, can be said to have consequences relative to holdings of monetary assets or liabilities. It has been argued that, if monetary assets are held during a time of rising prices, a loss is suffered in terms of purchasing power, measured by the difference between the purchasing power which these assets commanded when acquired and their current purchasing power; conversely, that a gain in terms of purchasing power arises when liabilities exist during a time of rising prices. The opposite applies in a time of falling prices. These losses and gains are not recognised in financial statements where the unit of account is the unit of money, unless specific steps are taken to do so.

Opinions differ considerably as to the justification or otherwise of bringing to account purchasing power gains or losses on monetary items. Broadly, three viewpoints can be distinguished:

- those who advocate that such gains or losses should be completely ignored;
- those who advocate that all such gains or losses should be brought to account;
- those who advocate that such gains or losses should be brought to account only to the extent that they relate to monetary assets and liabilities which form part of the working capital of the entity.

The question arises as to whether, and if so to what extent, CCA needs to take cognisance of such purchasing power gains or losses, for the purpose of profit determination. It could be argued that the capital and capital maintenance concepts underlying CCA would require recognition of purchasing power gains and losses in respect of monetary items included in the entity's working capital pool. This matter requires considerable further research, including adequate field testing, before any decision can be made as to the most appropriate accounting treatment.

In the meantime, CCA, as set out in Statement DPS 1.1/309.1 does not give recognition to purchasing power gains or losses on monetary assets and liabilities. To bring to account such gains or losses, a modification to the system would be needed."

The way this issue is decided will have a profound effect on the stated profit of companies that are substantial net borrowers or lenders.

This issue of gains and losses is of particular importance to investors assessing the investment worth of shares in a company. This is because profits under CCA will be based on the entity approach rather than the proprietorship approach used at present. Using the entity approach no account is taken of how the entity is financed as between proprietors, that is shareholders, and the lenders of debt capital. This has important implications for investment analysts as they endeavour to compare one company's shares with another's. Using Current Cost Accounting the profit is struck after making all necessary charges to maintain the operating capability of the entity. Consider now the position of the holders of the company's long-term debt, the debenture holders. In a time of inflation the real value of their stake in the company is diminished, and, since the real value of the entity is maintained, the real value of the proprietors interest in the company is increased. Thus it will be appropriate for investment analysts to attempt to measure the magnitude of this transfer of value, and to take it

into account in their assessment of the company's shares.

Thus using CCA accounts, in whatever form they may finally take, it will still be necessary for investment analysts to see how well they meet their needs. And to the extent that they do not, then to make adjustments accordingly.

This should not be seen as a criticism of CCA. As I said at the outset no one presentation of accounts is likely to meet the needs of all users.

Consider the position of the holders of the companies debt capital, its debentures. The certificate may proclaim the return to be 12.5%, but anybody who believes that this is in an economic sense a 'real' return is fooling themselves.

Similarly analysts must endeavour to determine some sort of "real" return to equity investors. It is premature to go into examples of this until we see how the Standard deals with monetary items.

This question of monetary items might be summed up as follows. Using the equity approach the question is not of major importance for the company as a whole. However, when we come to consider the separate position of those who provide debt capital, and those who provide equity capital, it is important and it has not yet been decided how this item is to be treated.

Response in the Stock Market

The quality of earnings measured under Current Cost Accounting will be quite different to earnings as we know them. Past ideas of dividend cover will be inappropriate and profits could be distributed in full. It is important that this be well understood when companies first report Current Cost Accounting profits.

When looking at the question of equities as a 'hedge against inflation' we must look not only at the method of accounting but at the acceptance of this method for the purposes of taxation, price fixing, and assessing capacity to pay in wage fixing negotiations. Given all these things there can be no doubt that equities will be an excellent 'hedge against inflation'. In these areas historical cost is a discredited method of profit measurement, and it seems to me unlikely that it will continue to be relevant in these areas when profit figures are published on the basis of Current Cost Accounting.

In fact, in so far as the operating capability of the entity is maintained, and inflation erodes the claims in 'real' terms of net creditors shares might

be regarded as a 'super hedge' against inflation. A more familiar example of this 'super hedge' phenomenon is an equity in a house which is partly financed by borrowing. When the value of the house rises by, say, 10% the value of the equity rises by a larger percentage.

Provided the basis of CCA is well explained, and the real position of companies improves as expected, and provided the government proceeds with the implementation of the Mathews Committee proposals for reform of company tax, I believe that the market will accept CCA without disruption.

What might apply to the market as a whole, need not apply to individual securities. The stated profit of companies with substantial net borrowings are vulnerable. I guess we could well see the Standard, when it is released, include adjustments for the monetary items that go to make up working capital, probably not adjusted by a general price index but by an index relating to the goods to which the monetary items apply. Thus if a plastics manufacturer carries a stock of plastic chips financed by credit extended by the chemical manufacturers this debt would be indexed by the same index that applies to the stock of plastic chips. Since most companies that are substantial net debtors borrow long-term to finance plant and buildings but might well have current liabilities no greater than their trade debtors this type of adjustment may not have a significant effect on the stated profits of debtor companies. Further discussion of this problem is premature.

Progress is being made overseas with CCA. The United Kingdom and New Zealand are both scheduled to bring in CCA shortly after us. This should go a long way towards ensuring that overseas investors are not confused by what we are doing.

If investors could be assured that Mathews type deductions were to be allowed in respect of depreciation as well as stock value adjustments the introduction of CCA would present very few problems. In the figures projected for 1977/78 non-finance companies will have a CCA profit of \$3,538m pre-tax. Yet unless they are allowed a tax deduction for depreciation based on the current cost of the plant consumed in producing this income, they will be taxed as if they had an income of \$5,878m.

In approaching the problems presented by the introduction of CCA it is important to remember that companies are faced with real problems which must be solved and they will not be solved by pretending they do not exist.