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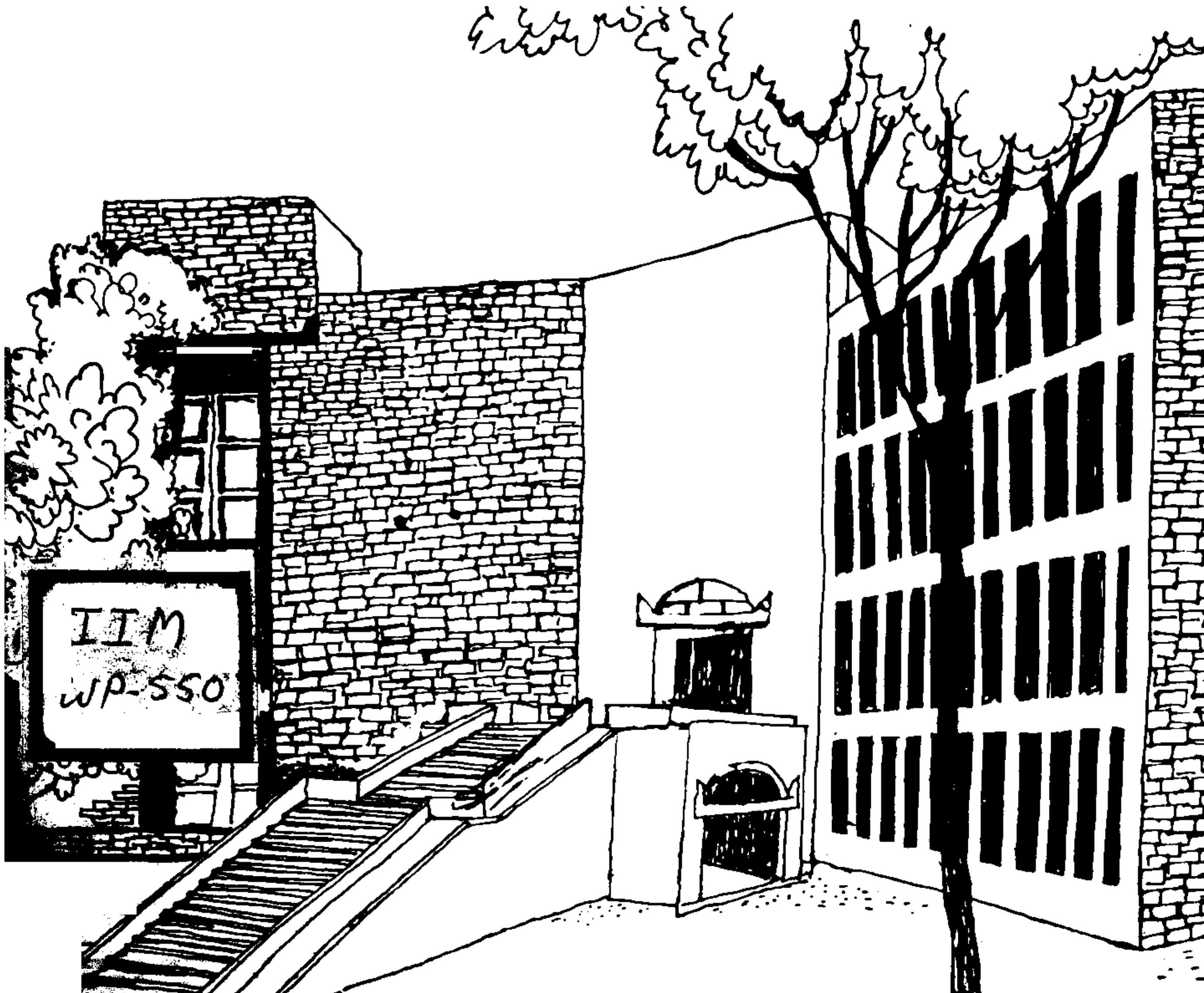

INFLATION ACCOUNTING: PERSPECTIVE
AND PROSPECTS

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INFLATION ACCOUNTING: PERSPECTIVE AND PROSPECTS

By
RAMESH GUPTA

During the last two decades, there have been several proposals on how financial statements should be adjusted to show the effects of inflation. The earlier suggestions were to adjust the financial statements using a general index such as the consumer price index (in the United Kingdom: SSAP-7 in 1974, in the United States: APB Statement number 3 in 1969 and FASB statement in 1974). These proposals were criticized because they did not indicate the effects of price changes specific to a particular enterprise. Price change for a given enterprise may vary considerably more or less than the general price changes.

Surprisingly the next move came from governmental sources, and the suggestion was to move from historical cost to some form of "current value accounting" (In the U.K.: Sandilands' Committee in 1975, in the United States: Security Exchange Commission's ASR 190 in 1976). Current value accounting is based on the concept of revaluing physical assets such as building, machinery, and inventory to their "value to the business".
The replacement of historical cost financial statements as primary statement was first suggested in 1980 by the U.K.'s SSAP-16. Issuance of SSAP-16 was considered an

important landmark in inflation accounting, but its acceptance remained doubtful.

More recent proposals have abandoned the "complete restatement" approach in favour of supplementary disclosure. The accounting bodies in various countries have opted to experiment the different approaches realizing that there is theoretically no "right" answer. Information provided by different methods of inflation accounting may prove valuable to different readers.

Problem areas:

All the formal proposals are approximately similar with respect to CCA treatment of both inventories/cost of sales and fixed assets/depreciation. The differences are more likely over the proposed treatment of monetary assets and liabilities (including gearing adjustment) and whether they present an "entity" view or a "proprietory" view of current cost accounting profit and loss account.

Almost all of the proposals differ in their treatment of these two matters. The UK's SSAP-16 emphasizes the entity view of the current cost profit and loss account. It requires, in addition to cost of sales adjustment and depreciation adjustment, a monetary working capital adjustment (MWCA) and a gearing adjustment in order to arrive at current cost profits attributable to shareholders. MWCA complements the cost of sales adjustment, and together they allow for the impact of price changes on the total amount of working capital used by the business in day to day operations. Gearing adjustment represents the movement in the "realized" element of current cost reserve which is financed by borrowings. For gearing adjustment, borrowing does not include funds borrowed for working capital requirements.

New Zealand follows the SSAP-16 approach except that the gearing ratio is applied to both "realized" and "unrealized" elements of the current cost reserve. Thus, the ratio is applied to the total movement in the current cost reserve during the period.

The Australian approach does not specifically require a monetary working capital adjustment; neverthless, the effect of the proposed approach is to bring about an adjustment to historical cost operating profit which approximates a monetary working capital adjustment.

This is achieved in two steps: by recognizing the net gain (loss) on holding all monetary assets and liabilities, and then by transferring to a reserve that portion of this net gain (loss) which arises from holding net monetary liabilities other than those included in MWC. The Australian approach prefers "entity" to "proprietory" notion of profit and, hence, does not recognize gearing adjustment or purchasing power gain (loss) on loan capital.

The United States' FAS 33 puts emphasis on proprietory view and does not differentiate between monetary working capital and other borrowings. It requires the disclosure of gain (loss) in purchasing power on holding "net monetary items". Such gain (loss) is a mere disclosure and is not adjusted against "Income from continuing operations".

The Canadian approach is a synthesis of the American and British approaches. It does not advocate monetary working capital adjustment, but computes financing adjustment (in place of gearing adjustment) and purchasing power gain (loss) on net monetary items. The information allows current cost income attributable to shareholders to be arrived at on both concepts of capital maintenance, the operating capability concept and the financial capital concept. Under the operating capability concept, the current cost income statement includes, in addition to cost of sales and depreciation on a current cost basis, a financing adjustment applied to the amount of total change (realized and unrealized) in the current cost of inventory and fixed assets during the period. Under the financial capital concept, the current cost income includes, in addition to cost of sales and depreciation adjustments, the change during the year in the current cost amounts of inventories and fixed assets and the general purchasing power gain or loss, but does not include financing adjustment. Like FAS 33, the inflation component of the change during the year in the current cost amounts of inventories and fixed assets is separately reported.

Current Status:

The United States: FAS 33 is now midway through its five-year experimental period. At the time of issuing the standard, a number of research projects to accumulate data and to monitor the implementation procedures were initiated by the Financial Accounting Standards Board (FASB). In January 1983, the FASB held a conference of researchers, financial analysts, and practising Certified Public Accountants to evaluate the research and preliminary results, identify key issues for future study and suggest ways of making the remainder of the changing prices experiment more meaningful. Some of the results presented in the conference were:

Historical cost earnings explain more of the changes in the stock prices than any FAS 33 earning measures. For example, in 1980, based on sample of 731 non-financial companies, historical cost earnings explained 21 per cent of the changes in stock prices versus 9 to 14 per cent for FAS 33 variables.

(2) FAS 33 data were not found to be of great valye in identifying investment takeover targets, but a model based on a combination of historical cost, constant dollar and current cost data could be superior in prediction.

(3) Current cost was generally preferred over historical cost by financial analysts because the former seems to yield better results in forecasting dividends of public corporations.

(4) The use of current cost data in management was found to be useful. It heightenes management awareness of the implications of changing prices.

(5) Regarding implementation problems, it was observed that none of the eleven corporations in varying industries surveyed had formalized approaches for intergrating inflation adjusted information into management decision processes. All said that the data had not been requested by external users and were unanimous in their opinion that the constant dollar approach should be eliminated.

Comments received on FAS 33 were mostly favourable. To encourage more research and experimentation in this area,

containing the quantitative disclosures

required by FAS-33 as well as codes that identify certain non-quantitative information is now available from Value Line Data Services. FASB plans to continuously update the data base of changing price disclosures.

On December 27, 1983 the FASB issued the Invitation to Comment (IC) "Supplementary Disclosures about the Effects of Changing Prices." IC discusses potential mid-course corrections in FAS 33 and related pronouncement. It is restricted to issues directly related to rescinding or amending FAS 33 and does not consider fundamentally different approaches to accounting for changing prices. It identifies four issues. The first two issues solicit views whether changing prices disclosure should be continued. The other two issues concerns potential amentments to the FAS 33 if some form of disclosure is continued.

Discussion in IC favours continuing the experiment, even though inflation has subsided. The arguments are: First, the effects of inflation are cumulative, so the effects of past inflation will take many years to work their way through financial statements. Second, if FAS 33 is rescinded now and the high rates of inflation return, the start-up costs to revive changing price disclosures might be greater than the costs of continuing the experiment. Third the data are not so useful in the first few years but a long time series of observations might greatly enhance the usefulness of the data.

If some form of disclosure is to continue, nobody favours the constant dollar and current cost data. Requirement of dual disclosure has been widely criticized as generating confusion. There are three options (1) disclose either constant dollar or current cost data but not both or (2) disclose only current cost data, or (3) disclose only constant dollar data. The first alternative would have companies with significant amount of inventory and fixed assets continue to disclose current cost data, whereas other would disclose constant dollar data. It is suggested that this approach would not impair the comparability of the current cost disclosures because companies with material amount of inventory and fixed assets would continue to report current cost data; for other companies the current cost and constant dollar disclosures required by FAS 33 are not significantly different. The discussion in IC favours this approach. The second alternative would require current cost disclosure for companies with significant amount of inventory and fixed assets and rescind the disclosure requirements for other companies. The third alternative would require companies to disclose only constant dollar data. These data are less costly to preapre and easy to verify, but a majority of participants in FASB January 1983 conference were against constant dollar data because they are not found to be useful.

There are two suggestion in IC with regard to change in disclosure format. First is to report "bottom line" that reconciles beginning-of-the-year and end-of-the-year stockholders' equity in average for-year dollars. This reconciliation would improve the quality of current cost data by explaining changes in net assets at the beginning and end of the year through income statement items. The second suggested change is to eliminate use of the base period (1967) for the CPI-U in the five-year-summary of key operating items. To improve comparability across companies these data in five-year summary would now be stated only in terms of the average-for-the-year or end-of-the-year constant dollars. This proposal should be welcome as most readers of financial reports think in terms of the recent purchasing power of the dollar. Moreover, few companies have reported in base-period dollars.

The last issue considered in IC is the changes to be made in current cost measures for fixed assets and depreciation. The relevance and reliability of current cost data for fixed assets and related depreciation have been questioned. The first modification suggested is to reduce the flexibility in selecting price indexes. Surveys have shown that companies have relied almost exclusively on indexes based on new assets prices. When original acquisition costs are multiplied by such price indexes, the result is an estimate of cost of reproduction (new). When such cost estimates are used, an explicit adjustment for, and disclosure of , differences in 'service potential' between a technologically improved new asset and asset-in-use should be required. Such adjustment should reflect the operating disadvantages of the assets owned owing to higher operating costs or lower output potential. One estimate is that such index amounts are 20 to 70 per cent higher than the fair market value.

The second modification is to require seperate determination of depreciations methods, estimates of useful lives, and salvage values. It is generally believed that the methods and estimates used for calculation in the primary financial statements have been chosen partly to allow for expected price changes, then different methods and estimates have to be used for purposes of current cost calculations. The third modification would be to require more detailed management discussion of how the data have been calculated. At a minimum, information should be required about measurement methods, service potential adjustments, and selection of depreciation lives. Analysts would be more likely to use data if their comparability among companies could be assessed.

The United Kingdom:

In the United Kingdom, the current cost accounting standard SSAP-16 came into effect in 1980. Since then, the standard is having an uneasy time. Although it is mandatory and calls for a complete set of current cost statements including an income statement and balance sheet, many companies have shown reservations in complying with it. Reservations expressed include the cost of compliance, the hypothetical and subjective nature of the information, and the irrelevance of the current cost concept to the particular company or the industry in which it operates. Some were frankly hostile, none more so than the Hewden-Stuart Plant in saying that, "in the opinion of your Board the accounts are certainly meaningless, possibly misleading and probably nonsense. They are of no practical value to the directors or the management of your company".

The dissatisfaction with SSAP-16 was so widespread and strong that a special meeting of the members of the Institute of Chartered Accountants in England and Wales (ICAEW) was called in July 1982 to consider a resolution "that the member of the ICAEW deplore the introduction of the Statement of Standard Accounting Practice-16 and call for its immediate withdrawal".

The resolution was defeated only by a very thin margin (15,745 to 14,812 votes). The vote did not result in a withdrawal of the SSAP-16, but its credibility was seriously shaken. The Accounting Standard Committee had to reconsider SSAP-16 and in July 1984, it has come out with ED-35 "Accounting for the Effects of Changing Prices". In this revised proposed standard, the changes relate principally to the disclosure requirements, and the companies to which they apply rather than to the concepts of how to account for the effects of changing prices. It comes into effect from January 1, 1985.

The statement applies to all public companies other than value based companies (e.g. insurance, investment, property dealing) and wholly owned subsidiary companies. Value based companies already report their assets at current values as part of their normal reporting processes. As for as disclosure requirements are concerned, the current cost information is to be given in a note to the main accounts rather than in supplementary current cost accounts. The information should show the effect of current cost adjustments namely, depreciation, COSA, MWCA and gearing on profit and loss account. However, if any adjustment amount is immaterial, it need not be reported. In addition, gross current cost of fixed assets and inventory, and the accumulated current cost depreciation are to be disclosed seperately.

Except for gearing, the methods for calculating current cost adjustment remain the same as those of SSAP-16. ED 35 gives a choice of three methods of calculating gearing. The SSAP-16 method may be continued. In this method, the gearing adjustment represents the movement in the "realized" element of the current cost reserve (i.e. sum of the three adjustments in the profits and loss account) which is financed by borrowings. Alternatively the gearing ratio may be applied to both 'realized' and 'unrealized' elements of the current cost reserve. This methods takes into account total balance sheet changes rather than the current cost adjustment in the profit and loss account. This method was first recommended by Newzealand CCA standard and reflects more closely the way banks and other lenders look at the company and assumes that in the long term a company will seek to maintain approximately the same gearing. The third option is to recognize purchasing power gains on debt based on movements in the general price index. This method is similar to the one recommended by Australia in its exposure draft on CCA. The three methods of calculating gearing will give significantly different results and therefore ED 35 insists, on disclosure of the method used in computing gearing adjustment.

In many ways, ED 35 is a damp squib. The disclosure requirements are reduced and the status of the current cost information is downgraded from a seperate set of accounts to a note. However, the problem of finding reliable and objective replacement values still remain. It would perhaps be a good deal more useful if ED 35 suggested reliable ways of finding replacement values rather than circling around the question of which adjustment to make and what to disclose. Whether companies will comply with ED 35 remains to be seen.

Canada:

The proposal of the Canadian Institute of Chartered Accountants (CICA) is the most comprehensive one on the subject of inflation accounting. After two exposure drafts, in December 1982 for the first time, CICA has included inflation accounting in its Handbook of accepted practices. The standard is officially called "Reporting the Effects of Changing Prices" and is included in the Supplementary Information Section 4510 of the CICA Handbook. The standard, like other CICA Handbook guidelines, carries an impressive legal weight because key business statutes such as the Canadian Business Corporation Act and several provincial acts stipulate that the financial statements should be prepared in accordance with the CICA Handbook. However, the inflation accounting standard, although part of the CICA Handbook, allows for information to be shown outside the financial statements as supplementary and need not be audited. Thus, the status and enforceability of the standard remains unclear.

Like Great Britain and the United States, Canada has opted to experiment with the different methods of accounting for changing prices. While releasing the standard, the CICA Research Manager modestly said that "it aims at pro-providing a kit illustrating the alternatives that a company can use in their statements in a way they will find most satisfactory".

The reporting requirements of the standard are similar to those of FAS 33, except that a financing adjustment would also be computed which would allow readers to arrive at the current cost income attributable to shareholders on both concepts of capital maintenance: the operating capability concept and the financial capital concept. The standard emphasizes the flexibility and experiementation on the part of management, but then it requires management to explicitly provide an explanatiob and a description of the bases and the methods of calculation and a narrative discussion of its significance for readers' benefit.

The experience of the first year of disclosure indicates that many companies are unwilling to accept the CICA's recommendations for voluntary disclosure. One reason is the lack of a clear demand from investors for the information. Another is that inflation itself has declined substantially. In addition, some have felt that the recommended disclosures result in a complex presentation that is difficult to interpret in a meaningful fashion. Future of section 4510 of the CICA Handbook remains uncertain.

The status of current cost accounting in other countries is fluid and confusing. There have been frequent issuances and withdrawals of current cost accounting standards by the respective national accounting standard setting agencies. One can only conclude that inflation accounting remains a controversial topic and is likely to continue to be so in the near future.