

# Inflation: Current accounting practice and the investment analyst

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## INTRODUCTION

After a continuous period of inflation over the last thirty years, criticism of the conventional form of financial reporting for failing to identify and isolate the effect of inflation has become increasingly vociferous. The disparity between book value and the related value placed on freehold property disclosed in recent take-over bids has brought forward the most recent suggestion that urgent reforms are needed in asset valuations and disclosure to shareholders.

The purpose of this article is to re-examine these criticisms, consider their validity and effect on financial analysts and the steps that are being taken to improve the position. It does not purport to present original thinking on the subject but merely provides a digest of recent views of authorities on the matter.

## CRITICISM OF CURRENT ACCOUNTING PRACTICE

Criticism of current accounting practice may be summarised in the fact that conventional financial statements do not purport to present the current value of a business or of its underlying assets or liabilities, nor does the profit and loss account reflect the net increase or decrease in the proprietor's real wealth over the period of the financial statements. Generally accepted accounting practice favours, and in the United States enshrines, presentation of accounts prepared on the historical cost basis. These accounts are not normally adjusted in an attempt to compensate for any change in the purchasing power of money.

In a period of perpetual inflation this practice produces the following results:

### 1

#### General

History is distorted as the unit of account varies from year to year and the extent to which the past trend reflected by orthodox financial statements has been affected by inflation is not apparent. For this reason investment analysts may not place complete reliance on the past performance of an undertaking, as reflected by conventional financial statements, for predicting future trends.

### 2

#### Fixed assets

Fixed asset costs reflected in the balance sheets are usually based on an accumulation of costs in dissimilar rands.

Thus two concerns may own adjacent, and apparently identical, freehold land reflected in their accounts at

widely different values due to the different prices ruling in the periods in which they were purchased.

A further complication arises because fixed assets which depreciate must eventually be replaced in a going concern. Conventional accounting requires that such assets be written off over their estimated useful lives to the business: it does not insist that the estimated increased cost of replacement be set aside over such lives. (\*See footnote.)

Theoretically, therefore, if an enterprise follows a policy of one hundred per cent dividend distribution, it may not have sufficient resources to replace a fixed asset at the termination of the useful life of its predecessor. It may thus be obliged to borrow merely to continue in business — a step usually associated with expansion.

### 3

#### Current assets

Any concern which holds trading stocks or sells the latter on credit must provide increased working capital in order to finance the same quantitative level of stock or debts.

Conventional accounting again enables a full distribution of profits to be made to shareholders without providing for the increased cost of replacement of such assets.

### 4

#### Foreign currency liabilities

Local accounting practice does not currently demand that the repayment period of long-term borrowings be set out in the accounts nor that details be given of the currency in which such borrowings are to be repaid.

In our current climate of floating exchange rates and variations in rates of national inflations this is a notable omission in our standard of financial reporting.

### 5

#### Financing

If a company finances its operations from internally generated funds part of the cost of such financing is the depreciation, in real terms, between the value of the rands held at the beginning and end of the period. This may be termed the 'cost of owning money'. Similarly, the cost of borrowing funds at fixed rates of interest is reduced by a similar 'gain in borrowing money'.

Conventional accounting ignores both these aspects.

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\*Current accounting practice is not alone in ignoring this aspect. Taxation authorities, including our own, largely ignore this problem and tend to levy taxation on conventionally calculated income. It is true that at present our investment allowances have a mitigating effect of between

four to ten percent of such increase in replacement price. This is largely coincidental and the introduction of such allowances tends to be timed to stimulate depressed economic conditions and not to relieve the inflationary effects of boom conditions.

### IMPLICATIONS OF CURRENT ACCOUNTING PRACTICE ON FINANCIAL ANALYSTS

The drawbacks of current accounting practice outlined above tend to result in the reflection of enhanced profits in orthodox accounts. This overstatement effect is perpetuated in the historical ratios which financial analysts compute such as dividend covers, earnings yields and covers, and price-earnings ratios.

In addition, if fixed assets are held over a considerable period, or major liabilities are only refundable in the distant future, the balance sheet may become completely divorced from current values. The capital employed in the business thus becomes understated and the return on capital employed is overstated.

The extent to which any financial statements are affected by such distortions is not readily detectable from an examination of the statements. Some operations are affected more than others; more distortion is produced by some periods than others. Comparison of past performances of the results of different concerns and estimation of future investment potential thus becomes difficult.

### REMEDIAL ACTION

In discussing remedial action accounting literature abounds with the terms 'general price-level restatement' and 'current value accounting' and it is as well to clarify the meaning of these terms at the outset. They are not mutually exclusive alternative remedies but may both be adopted in the same financial statements.

In essence, general price-level restatement is the accounting process of changing the standard used to compare varying resources from units of money to units of general purchasing power. This process is normally effected by means of selected indices: for example, current rands are changed to the purchasing power of rands at a standard date by the application of such indices.

Once the standard has been chosen with which to measure resources the relationship between the resources and the standard must be determined.

Four examples of such relationships are:

The quantity of the standard:

- 1 that is sacrificed to obtain the resource (historical cost);
- 2 that can be obtained in exchange for the resource (selling price);
- 3 that is required to replace the resource (replacement price);
- 4 that will be obtained in the future in exchange for the resource or its product (future net receipts).

The last three examples are all illustrations of current value accounting relationships.

Under current usage units of money are used as the standard and historical cost, the money sacrificed to obtain non-money resources, provides the normal relationship.

Thus the standard alone may be changed (general price-level restatement), only the emphasised relationship may be changed (current value accounting) or both may be changed simultaneously.

Having distinguished between 'general price-level restatement' and 'current value accounting' a more detailed examination of these proposed solutions to accounting in a period of changing price-levels is set out below.

### GENERAL PRICE-LEVEL RESTATEMENT (GPA)

This method has been recommended by the American Institute of Certified Public Accountants (AICPA) in Accounting Principles Board Statement 3, and by the Accounting Standards Steering Committee of the Institute of Chartered Accountants in England and Wales (ICA) in their exposure Draft 8.

An attempt has not been made in either of the above pronouncements to introduce current value accounting — the historical cost basis has been maintained. Both pronouncements are concerned purely with isolating and measuring the effects of inflation: they do not purport to measure or isolate changes in real value arising from other causes.

Within this framework the main difficulty, as may be expected, is the choice of a suitable index with which to convert currency to units of purchasing power. The AICPA recommends the gross national product implicit price deflator index and the ICA the consumer price index. Neither index is ideal for universal usage and may produce anomalies: to restate the value of a motor vehicle because of the effect of potato blight on the consumer price index would not appear logical.

In addition both pronouncements recommend that financial statements incorporating these indices should be ancillary to the orthodox ones and should not supplant them.

This method of restatement of accounts, although suggested for some time, has not received universal support. A reason for this is an understandable reluctance on the part of individual firms to underline the proportion of their apparent progress which in fact is derived from the erosion through inflation of the value of the unit of measurement. Another factor is that the inappropriateness of indices in certain situations throws doubt on their universal applicability.

### CURRENT VALUE ACCOUNTING (CVA)

The most usual and publicised variant of this manner of accounting is replacement price or replacement value: Philips of Holland is a well known advocate of it.

Other variants such as selling price or realisable value may be used. Such a variant is not often recommended as financial statements of most undertakings are prepared on the going concern basis: their continued existence is assumed. To restructure the statements on what amounts to a net realisable or scrap value basis would appear unrealistic, except in cases in which undertakings give indications of ceasing to trade. In addition, the true value of any article or combination of articles can only be determined by the price at which current agreement is reached between a willing buyer and a willing seller. Should such transactions not have taken place at a convenient time, any valuation becomes an expression of opinion which may or may not be reliable.

Only the replacement value variant of CVA is thus examined in this article. Under this variant the trading

account is charged with the estimated cost of replacement of the articles consumed in production and subsequent sales and fixed assets are depreciated according to their estimated replacement value. In principle this appears simple: in practice it is fraught with difficulties such as:

- 1 Fixed assets are seldom replaced by identical units. This is particularly true in periods of rapid technological progress.
- 2 Stocks are not always replaced by identical units and their replacement price depends on the volume carried, the level of demand and the stock turnover ratio.

Apart from the above practical difficulties there are theoretical objections to this CVA approach as a means of arriving at true profit. True wealth is not necessarily maintained if there is no change in physical possessions: they may lose or gain value in exchange as much as money. Replacement value accounting attempts to measure true profits by substituting for the measure money only those commodities that the individual undertakings possess. By superimposing GPA on to the current rands used in the replacement value version of CVA the estimated inflation effect may be isolated. This procedure is, however, likely to be laborious and ineffective.

### CONCLUSION

Conventional accounting with its reliance on the historical cost basis and comparison of currencies with dissimilar purchasing power distorts the true progress of a business. The effect of inflation is ignored and the financial statements in a period of continuous inflation tend to bear no relationship to current values.

Whilst this position exists financial analysts should be aware of this distortion and of the ways in which such distortion has affected, and may affect, two concerns in different ways.

Remedial action has been proposed by means of general price-level restatement (GPA) and current value accounting (CVA). GPA retains the historical cost approach and merely attempts to isolate effects of inflation by the use of indices: an attempt is not made to use any form of CVA.

CVA, and particularly the most popular form of it: replacement value accounting, is a bolder attempt to restructure accounts on a basis designed to retain the reflection of current worth. CVA may be used in conjunction with GPA in an attempt to isolate the effect of inflation from other factors affecting the current value.

The use of CVA and GPA or a combination of both, has its drawbacks. Despite these drawbacks, however, their use provides considerable advantages over orthodox accounts, and financial analysts and the financial community as a whole should at least advocate the compulsory usage of GPA on an ancillary basis in financial statements presented in South Africa. Once historical information is regularly presented in this manner more attention may be paid to its use in the preparation of budgets and anticipation of future investment decisions.

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