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POST – WAR DEVELOPMENT IN ACCOUNTING FOR INFLATION (FINANCE IN CONTEXT)

PRESENTED BY

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POST- WAR DEVELOPMENTS IN ACCOUNTING FOR INFLATION

The purpose of this introductory paper is to trace the development of inflation accounting over the past thirty years. It may be said of this period that as the rate of inflation fluctuated, so too did the interest of accountants. In the early 1950s, the Korean War having been a main cause of the upsurge in· inflation, interest in inflation accounting sharpened. As the rate of increase in inflation diminished – to stabilize at low levels during the 1960s – so interest waned. Then for a time, the problem was generally ignored.

The sharp rise in inflation in the 1970s called for an urgent reconsideration of the subject. The Accounting Standards Committee (ASC) responded by first favouring a system of current purchasing power accounting (CPP) but then, following Government intervention, moved to recommend as system of value accounting labelled current cost accounting (CCA). However, their recommendations of this system (Exposure Draft 18) were rejected by the profession as complicated, impracticable and too vague in relation to the definition of distributable profit. CCA was to replace the well tried system of historic cost accounting (HCA). There was strong reaction against this.

In November 1977, an interim compromises solution, in the shape of the Hyde proposals, was announced. This is basically a simple supplementary CCA statement to the historic cost accounts. Reactions to the proposals varied. There were those who greeted with relief their concise simplicity and did not want any elaboration, feeling they were all that would be necessary in the long run. Others welcome the suggestions only as a first step in the right direction.

After 30 years of argument and with inflation rates still high, though now in single figures, there is still no general acceptance of an inflation accounting system, and most published accounts do not indicate its effect. Some leading Public Companies until recently offered CPP statements, others use CCA, but most do little or nothing.

The accountancy profession is divided on the future of inflation accounting, but is showing a united front behind the Hyde Proposals.

Recommendations in the early 1950s

At the time of rising inflation rates in the 1950s the Councils of both The Institute of Chartered Accountants in England and Wales and The Association of Certified Accountants published statements reflecting that:

1. Fixed assets appeared in balance sheets at values much below their replacement cost.
2. Depreciation being provide on those values distorted profits because turnover was in terms of depreciated sterling, and
3. This proved inadequate to provide amounts out of profits for fixed asset replacement.

The Statement of the Institute

The Council cannot emphasize to strongly that the significance of accounts prepared on the basis of historical cost is subject to limitations, not the least of which is that the monetary unit in which the accounts are prepared is not a stable unit of measurement. In consequence the results shown by accounts prepared on the basis of historical cost are not a measure of increase or decrease in wealth in terms of purchasing power; nor do the results necessarily represent the amount which can prudently be regarded as available for distribution, having regard to the financial equipments of the business. Similarly the results shown by such accounts are not necessarily suitable for purpose such as price fixing, wage negotiations and taxation, unless in using them for these purpose due regard is paid to the amount of profit which has been retained in the business for its maintenance.

On the other hand the alternatives to historical cost which have so far been suggested appear to have serious defects and their logical application would raise social and economic issues going far beyond the realm of accountancy. The Council is therefore unable to regard any of the suggestions so far made as being acceptable to the existing accounting principles based on historical cost.

Unless and until a practicable and generally acceptable alternative is available, the Council recommends that the accounting principles set out below should continue to be applied:

(a) Historical cost should continue to be the basis on which annual accounts should be prepared and, in consequence the basis on which profits shown by such accounts are computed.

(b) Any amount set aside out of profits in recognition of the effects which changes in the purchasing power of money have had on the affaires of the business (including any amount to finance the increase in the cost of replacements, whether of fixed or current asset) should be treated as a transfer to reserve and not as a charge in arriving at profits. If such a transfer is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately, since it is not the whole of the profits.

(c) In order to emphasize that as a matter of prudence the amount so set aside is, for the time being regarded by the directors as not available for distribution, it should normally be treated as a capital reserve.

(d) For balance sheet purposes fixed assets should not be written up, especially in the absence of monetary stability.

'The Council also recommends to members who are directors or officers of companies or who are asked by clients for advice, that they should stress the limitations on the significance of profits computed on the basis of historical cost in periods of material changes in the purchasing power of money; and that they should draw attention to the desirability of:

(a) Setting amounts aside from profits to reserve in recognition of the effect on the amount of profit which, as a matter of policy, can prudently be regarded as available for distribution.

(b) Showing in the director's report or otherwise the effects which changes in the purchasing power of money have had on the affairs of the business, including in particular the financial equipments for its maintenance and the directors' policy for meeting those requirements, either by setting aside to reserve or by raising new capital.

(c) Experimenting with methods of measuring the effects of changes in the purchasing power of money on profit and on financial requirements. If the result of such experiments are published as part of the documents accompanying the annual accounts, the basis used for the calculations and the significance of the figures in relation to the business concerned should be stated clearly.

The Statement of the Association

In dealing with depreciation we must for the sake of clarity and simplicity define the nature and purpose of depreciation.

For our purpose we take depreciation in the narrower sense as the diminution in value which a physical asset suffers through us and the effect of time and which cannot be made good by maintenance. We leave out of account the wider interpretation of depreciation which includes the loss of value of assets due also to changes in economic conditions, such as changes in consuming habits or methods and techniques of production, which is compendiously termed consumption obsolescence. For present purposes we define depreciation in the narrower sense as the consumption of utility value spread over the life of the asset, which cannot be recovered by maintenance. The essence of this definition is that it is not dependent on replacement, although the measure of value that has been consumed can only be correctly on replacement, The physical deterioration of an asset is an expense incurred now, during the current accounting period, whether this asset will or will not be replaced at a later date. The purpose of the depreciation charge is not to provide for a fund for replacing the asset (although that may be its incidental and useful result) but for accounting as an expense the cost of using it up. Depreciation is first and foremost the recovery, spread over the life of the asset, of the prepaid cost incurred by its acquisition.

An annual charge which will do this is the minimum that must be charged against current operations during the useful life of the asset. But if – owing to the inflationary rise in prices – this charge is lower than it would be if it were calculated on the same cost basis as other items of expenditure, e.g. maintenance and repair, then expenses are understated and profits overstated.

To remedy this the depreciation charge can be divided in two parts:

(a) The basic charge, calculated on recorded cost and designed to recover it over the useful life of the asset; and

(b) A supplementary charge for the difference by which the basic charge falls short of the amount which would appear as an expense if it were calculated on a basis homogeneous with maintenance, repair and other current expenses.

The practical application of this convention would not create great technical difficulties, nor would it cause a breach in the structure of accounting principles. In fact the whole system of accounts would remain unchanged, up to and including the trading or manufacturing account, where the basic depreciation would be account for. The balance – the trading profit – could be brought to a depreciation adjustment account where the supplementary depreciation could be charged. The balance would be carried to the profit and loss account. The basic depreciation would continue to be deducted from the book value of the assets in the balance sheet and the supplementary depreciation brought to a special replacement provision account.

It must be admitted that the choice of the co-efficient to be used for measuring the trend in the purchasing power of money as regards its application to the current value of fixed asset presents some difficulty, for there does not appear to be available an index of prices which is closely suitable. The cost of living index has the advantage that it is official and is perhaps the nearest approach towards measuring the general trend of the purchasing power of money, but it is doubtful whether it is satisfactory for the purpose of fixed assets. Here, it seems, a more specialized index more heavily weighted for fluctuations of wholesale prices of raw materials and for movement in wages, would be more satisfactory. No such comprehensive or official index appears to exist.

It can be seen that both bodies advocated that while inflation persisted, it was necessary to set aside an additional annual sum for depreciation over and above that based on historical cost. The Association preferred a replacement cost expense basis of charging depreciation against profit, while the Institute saw the additional sum of the nature of a reserve to be treated so in the accounts. There was no recommendation to write up the fixed assets to replacement values.

Two problems followed from these suggestions. First, the Government offered no acceptance of replacement cost depreciation for tax purposes. Secondly, as one economist put it at the time, 'you had to be pretty strong financially to set aside supplementary sums out of reserves. If the Inland Revenue has put you through their sieve first, and your profits are taxed, many firms may not be strong enough to pay the tax and out of what remains set aside adequate funds to cover the loss of value due to inflation.

Understanding of property values

One result arising in the 1950s and early 1960s of maintaining fixed assets in books of account at historic costs, particularly property, was that capital employed remained understated in value, and profits reported as a percentage of such capital employed were higher than they would have been following revaluation. The other result was that share prices did not fully represent the truce underlying asset value of capital employed. Consequently, companies were exposed to take-over bidders with more certain knowledge of the current values of properties than the directors or shareholders themselves. Share price offers sufficiently above current market values to attract shareholders were below realistic prices based on the inclusion of current property values. Large gains were made by speculators at the expense of shareholders.

Legislation – Companies Act 1967

Section 16(1a) of the 1967 Act was introduced to deal with this problem and required directors to report to shareholders if, in their opinion, there was any significant and substantial difference between the book and market value of land (including buildings thereon).

This requirement, left to the discretion of directors, does not appear to have achieved it objective. Many boards continued not to keep their shareholders informed, as these examples indicate.

The market value of certain freehold property owned is considerable in excess of the book value, but the directors feel it inappropriate to estimate what that surplus may be.' The land and buildings of the group are, for all practical purposes, fully utilized for manufacturing and trading operations. In view of this, the directors are of the opinion that a market valuation of land and buildings as compared with book value would not be of significance.'

In the latter case - and example of many using the same argument – the decision is based on the truism that the land and buildings were owned for the purpose of the company's business with no intention of disposal. Therefore, if was argued, there was no advantage to the shareholders in estimating current values. This short-sighted view would appear to be motivated, inter alia, by the objective of maintaining assets and thus capital employed at historic costs, ensuring a higher rate of earned profit thereon than would be the case of assets were revalued.

The group, whose statement is first quoted, is purported to have realized major property within a short time of its year end for £30 million more than its book value. No doubt members who had disposed of their shares earlier would feel aggrieved.

Disclosure of more realistic net asset values would have allowed shareholders to compare their share of such value against.

1. The return obtained.
2. The market price of the share, and
3. The over afforded.

The English Institute's Survey of Published Accounts 1971-72 reported that out of 300 major
Companies surveyed, only 121 had revalued properties and no more than 32 their fixed assets, within the previous five years.

In a 1968 publication of the Research Committee of The Institute of Chartered Accountants in England and Wales. Accounting for Stewardship in a period of Inflation, a forerunner of ED8, the proposal was put favouring adjustments to accounts for changes in the general price level. The booklet generally restricted itself to the mechanics of the system. The choice was subsequently supported by the ASC in a discussion paper, but in neither document was there much debate on the reasons for the decision.

Developments in the 1970s

An important aspect of the maintenance of historic cost accounting was the widespread reporting of profits earned at a higher lever than was the case when rising replacement costs and the falling value of money were considered. While in the 1960s inflation ran at a compound annual rate of 3%, this was regarded as less significant, but when in the early 1970s short-term increase in the Retail Price Index reached 10 per cent and then went quickly higher the effect became traumatic, Profits were taxed at a much higher rate than appeared to be the case and, after paying dividends, companies retained profits were inadequate for the replacement of fixed assets and the maintenance of working capital, and still more inadequate for business expansion.

In 1974 the Government Introduced, on a temporary basis, stock relief for tax purposes. This had the intention of eliminating inflationary ' stock profits' from taxable earnings and this together with a 100% capital allowance on certain capital expenditure, offered a major alleviation of the problem.

Current purchasing power accounting

Following the discussion paper (1971) of the Accounting Standards Committee, mentioned above, came the publication in January 1973 of Exposure Draft ED8[2], " Accounting for changes in the purchasing power of money."

The recommended method, which was to start with public quoted companies early in 1974, was based on the use of a single index representative of general purchasing power and was to be by way of supplementary information to the published account. There was no question of departing from historic cost account. Because of the relative simplicity of the system and the use of the one independently produced verifiable index, the system was attractive to the audit side of the profession.

The Exposure Draft on CPP accounting received the qualified support of the Confederation of British Industry's Barran Committee, whose views were published simultaneously with ED8. In so doing, they said:

The committee is conscious that the problems posed by the effects on financial statements of changes in the value of money are so serious and pressing that they require urgent action… speedy action is possibly more important than the search for perfection.

In a reference to the importance of accounting for inflation in management accounts, they continued:

The more management has already taken account of inflation and planned the financing of its growth accordingly, the less will the production of a corrected statement of accounts affect the allocation of resources.

If the true position goes unappreciated, they said, there will need to be a complete review of policy across the functions of business, e.g., in relation to selling prices and cost of production so, the longer such a review is delayed, the more critical will be the consequences of the unchecked erosion of profits and of assets, through inadequate depreciation provision, resulting from inflation.

The CBI report concluded:
'It need hardly be said that if it is agreed that changes are needed, the longer present historic accounting alone is continued, the more companies and the public will be deceiving themselves. The continued erosion of real capital and company earning would almost certainly lead to more critical difficulties to be faced eventually.

The Sandilands Report
Time, then, was of the essence, and speed of action was seen as essential. The ASC were moving towards an accounting standard. However, on 25th July, 1973, the Government dropped a bombshell. The Secretary for Trade and Industry in the then Conservative Government announced the formation of a Government Committee to enquire into the necessity and possible method of accounting for inflation. Its terms of reference were whether (writer's emphasis) and if so how, company accounts should allow for change in costs and prices, having regard to established historic accounting conventions and the proposals put forward by the ASC (I.e. CPP accounting) and other possible methods.

This unexpected announcement was received by accountants with some incredulity. They had spent over two year investigating the matter and in view of the fundamental change likely for company accounting many of the senior members of the profession has been involve. Further, the Department of Trade and Industry representative on the plenary body which worked in consultation with the ASC had voiced no disagreement before the publication of ED8.

The ASC's movement towards a standard was thus, rather rudely, halted. In December 1973, Mr. (now Sir) Francis Sandilands was named as Chairman, and in January 1974 the Committee's term of reference and its membership were announced in the House of Commons. The New Labour Government in March 1974 gave the Committee its blessing to go ahead.

In the meantime, the accountancy bodies decided that then when their standard on CCP accounting was issued, it should be provision pending the outcome of the Sandilands enquiry. It would not be mandatory and auditors would not be required to qualify accounts which did not contain a supplementary current purchasing power statement. The provisional standard (PSSAP 7)[3] was published in May 1974, recommending that all listed companies should follow it. That standard is still extant, but it is probable that only a small number of companies are adhering to its use.

The Sandilands Committee acted with great speed and independence of thought and presented its report to the Secretary of Trade on 25th June 1975. Nevertheless this was nearly two years since the proposal of the Government Committee had been announced and was a measure of the delay in the introduction of a system of accounting for inflation seen by many as being urgently required.

To the dismay of the ASC, the Committee rejected the accountants' CPP method and came our in favour of accounts drawn up on a current cost accounting (CCA) principle. It defined this basis in relation to asset valuations as' value to the business', in place of historic cost. In determining profit, 'holding gains' and extraordinary gains' should be differentiated from operating profit. The firm intention was that the system of historic cost accounting should go, to be replace by the new system. The possibility of a supplementary statement to HCA was rejected.

The Sandilands Report (Cmnd 6225) was published in September 1975[4]. The early chapters should be of absorbing interest to students, dealing as they do with the underlying theory of conventional accounting systems.

Progress post-sandilands
The sandilands Committee recommended to the Government that the changes should be supervised by the accountancy bodies, aiming to introduce CCA for published accounts for accounting periods starting after the 24th December, 1977. In January 1967, the Consultative Committee of the Accountancy Bodies (CCAB) announced the composition of its working party to be led by Douglas Morpeth. In the interim period, companies were recommended to supplement their accounts with a statement adjusting the results and financial position of the company for the effects of specific and general price-level changes. They were recommended to use current cost methods or the CPP method set out in PSSAP7.

The CCAB's Government-sponsored steering group set up five working parties:

1. To consider the problem of valuing fixed assets and calculating depreciation;
2. To examine problems in valuing stocking and calculation cost of sales adjustments;
3. To Examine legal implications;
4. To prepare instruction manuals;
5. To consider problems arising from the treatment of liabilities and monetary assets and the valuation of marketable and unquoted securities.

The last item was one which stimulated considerable controversy. There were still many adherents of the CPP system and many had suggested that CCA was not in fact a system of inflation accounting. So it was not surprising to find those who suggested a combination of the two methods.

Not surprisingly, therefore, the Stock Exchange in January 1976, asked listed companies to put themselves in apposition to produce full CCA accounts together with a statement of the effect of inflation on shareholders' funds as soon as possible. They recommended that the supplementary statement should contain information on:

1. The cost of sales adjustment in relation to stock consumed.
2. The value to the business of the assets being depreciated and the amount of depreciation chargeable on such value;

3. The current purchasing power adjustment to net monetary assets or liabilities.

The CCAB initial reactions to the Sandilands report in December 1975 had also considered the some form of combination was desirable. It had concluded that in the interests of finding a workable system as soon as possible, an accounting standard should be developed based on the Sandilands report but with certain alterations. These included:

1. A statement to be included in the accounts showing a comparison between the change in the capital invested, as measured by CCA, with the change required to maintain the purchasing power of capital.
2. In any summary of past results key figures should be expressed in terms of current purchasing power at the balance sheet date.

Exposure draft 18: Current cost Accounting.

Working to a tight programme, the Steering Group produced ED18, Current Cost Accounting on the 30th November 1976. The detailed booklet ran to some 93 pages and it was supported by the publication of a guidance manual containing another 278 pages of detailed and comprehensive coverage. The chairman of the Accounting Standard Committee from 1970 to 1976 subsequently wrote:

I believe the timetables set up were impractical. I am sure that the ASC should have had much more time to consider ED18. Accounting standards in the past were drafted by working groups similar to ht inflation Accounting steering Group, although with Government representation, and were often referred back by the ASC and sometimes substantially, amended by that Committee.

Be that as it may, the exposure draft and the accompanying guidance manual was a remarkable piece of work to have been produced in such detail in so short a time. There was a pause while the work was considered and there followed then a greal deal of criticism, not only for academics who had been naturally voluble through our the whole of the 1970's progress of the debate on inflation accounting, but now from the grass roots of the profession itself.

Responding to criticisms of complexity, the Secretary of the Inflation Accounting Steering Group (IASG) wrote:

'Critics who make this particular point would appear to be confusing length with complexity. We have endeavoured to provide a reasonably comprehensive guide to the totality off a new accounting system. One should not compare ED18 with previous exposure drafts, but with the length of an exposure draft required to describe, for example, the historic accounting system.'

But it soon became apparent that the profession was not ready for a 'totally new accounting system' and regarded it as impracticable to abandon historic cost accounting as the primary form of accounts.

Notably, however, it was the vagueness of ED18 about distribution and retentions of profit-matters which it was suggested should be left entirely to the determination of the directors using their discretion which some saw as completely undermining the whole purpose of CCA – which contributed largely to its rejection. The Auditing Practices Committee concluded that it was impossible to audit the Ed18 proposed appropriation account.

The Institute of Cost of Management Accounting's submission on ED18 desired a simplified system of inflation accounting involving only cost of sales and depreciation adjustments and wanted further research to ascertain whether the two adjustments could be included in the tradition profit and loss account.

It was evident that there was widespread feeling against the abandonment of historical cost accounting as the primary form of accounts. The extensive criticism and opposition culminated in the requisition of a special meeting of members of the English Institute of Chartered Accountants in July 1977, when a motion calling on the Institute not to make CCA compulsory was put and accepted. Another cross roads on the journey to an acceptable inflation accounting system had been reached.

The Hyde Guidelines

Following that meeting, that was little surprise at the abandonment of the proposed (CCA) standard by the ASC who announced that it would publish guidelines for a voluntary system to cover three items on corporate books, ie, cost of sales, depreciation and gearing. Gearing is a novel feature and its intention is to ensure that the full burden of the first two adjustments should not fall upon the shareholders where they have not financed the whole of the assets in respect of which those adjustments arise.

The ASC apparently sees the guidelines as an interim measure to cope with the urgent need for accurate accounts now while the details of a proper standard are worked out by the IASG.

The guidelines produced by the ASC sub-committee were published early in November 1977 with the knowledge and tentative support of the CBI and the Stock Exchange. It recommended that list companies include in their accounts 'a prominent separate statement giving inflation adjusted figures'.

This statement will start with the historic cost based profit for the year before taxation and be adjusted by separately disclosed cost of sales and depreciation adjustments and finally amended by a gearing adjustment.

It is recommended that this 'price level accounting statement' should be included in accounts for periods ending on or after 31st December, 1977. Besides the recommendation to listed companies, wider adoption is urged in the interests of more informative reporting.

The 'grass roots' accountants have got what they wanted. Historic accounts are left untouched. The guidelines are short, recommend the use of official indices and give plenty of latitude for existing systems to be adapted.

Only time will tell whether this interim solution will become permanent.
In July 1978, the ASC issued as 'statement of intent' as a reassurance to companies about the contents of an exposure draft to be published in the spring of 1979. The exposure draft will only be a slight evolution from the 'interim Hyde proposals' and will not make any major changes from the present practice.
No decision has been taken on the length of the exposure period, so no date has been set for the implementation of the subsequent standard.

With the exposure draft will come detailed guidance notes and a document on voluntary principles for small business.

This standard will require the publication of a CCA statement in addition to the historic cost profit and loss account, and the latter will not be replaced in the near future. The standard will also require a CCA balance sheet, probably acceptable in summarised form. It will apply only to listed companies and other large undertakings, and the relative size criterion is yet to be decided.

The ASC reported that the response to the interim recommendations had been encouraging and strongly urged all relevant companies to apply and continue to apply them.

Reference:

1. 'Depreciation and inflation – an economist's view', Roy Harrod in an address to The Association of Certified Accountants.
2. Accounting Standards Committee -'Accounting for Changes in the Purchasing Power of Money'. ED8 Institute of Chartered Accountants in England and Wales (ICAEW) 17.1.73.
3. Accounting Standards Committee – 'Accounting for Changes in the Purchasing Power of Money', PSSAP7. (I CAEW). May 1974.
4. Report of the Inflation Accounting Committee under the Chairmanship of Francis Sandilands – 'Inflation Accounting', Cmnd 6225, (HMSO, September 1975).
5. Accounting Standards Committee – ED 18 ' Current Cost Accounting' 30 11.76.
6. Sir Ronald Leach in an article in 'Accountants weekly' 11.11.77.
7. Letter to 'the times' newspaper 22.2.77 by the Secretary of the Inflation Accounting Steering Group.