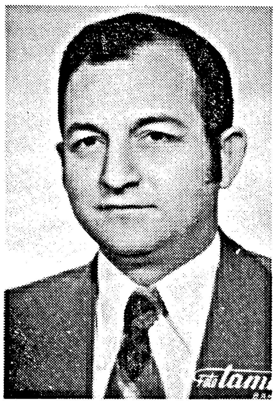
ON SOME DANGERS OF INFLATION ACCOUNTING



Die doel van hierdie artikel is nie om 'n indringende omskrywing te gee van metodes wat in Suid-Afrika gebruik word om finansiële state aan te pas by inflasie nie. Die skrywer stel meer basiese vrae, nl. waarheen is die rekenmeestersprofessie op pad met al dié verskillende metodes? Hoe kan 'n maatskappy se finansiële state oor tyd ontleed word as verskillende metodes gebruik word? Hoe kan maatskappye in verskillende lande met mekaar vergelyk word op grond van hulle finansiële state? Hy kom tot die slotsom dat die rekenmeesters-professie die sosiale verantwoordelikheid dra om hulle kragte te wy aan pogings om inflasie die hoof te bied en nie om nog meer verwarring te help skep nie.

By *Mustafa A. Aysan**

Methods of valuation in accounting have multiplied with the efforts of the accounting profession in trying to adjust the financial statements of business firms to rapidly changing prices of the Seventies. Even the very conservative professional institutions of The United Kingdom and the U.S.A. have created methods of reflecting rising prices in the financial statements. The Accounting Profession of South Africa, joined the international trend by publishing a Discussion Paper on 23 May 1975[1] recommending a combination of "current value" and "general purchasing power" methods of adjustment[2] for implementation. The purpose of this article is not a thorough definition of the S.A. method of adjusting financial statements to inflation. I would like to pose a more basic question: Where is the Accounting Profession headed with all these different kinds of valuations? How can financial statements of a company be analized over time, if different methods of valuation were employed? How could companies in different countries be compared on financial statements?

HOW MANY DIFFERENT METHODS OF VALUATION IN THE WORLD?

The Accounting Profession, in many countries of the World, was having enough problems with asset valuations at historical costs, with too many general definitions of "historical cost" and different interpretations of those definitions. Some well known examples follow:

- Should the company capitalize interest or expense it? It really depends on the profitability of the period in question. Accounting conventions allow for both treatments.
- When should we start depreciating an asset, carried in books at historical cost? It depends on management decisions.
- Which of the six methods of stock (inventory) valuation should the company use? According to accounting rules and regulations, selection of a method of inventory valuation is left to the discretion of the management.[3]

The above list can be expanded further. However, the above examples will suffice to demonstrate that different treatments of the above cases would change periodical profit figures, phenomenally, even when all assets are valued at historical cost. You may be sure that different treatments are presently being employed in all companies of the World. My observations and experience in several countries, have indicated that the periodic profit, is really a discretionary figure, on the whole, depending on the accounting policy decisions taken by the top managements of companies.

However, my intention here, is not having a complete review of accounting rules and regulations. The deficiences of accounting conventions are very well known and publicized all over the World. The intent here, is to indicate that the efforts of the Accounting Profession in "inflation accounting" have added further complications to the picture.

HOW MANY METHODS OF INFLATION ACCOUNTING?

In South Africa and elsewhere, companies have started publishing both historical and adjusted-to-inflation accounts in Annual Reports. A review of such reports has indicated[4] that, without the sub-classification of differences in treatment of certain asset items, 5 major methods of Inflation Accounting were in use:

1. *Current Purchasing Power (CPP) basis:* All-items in the financial statements are measured on the

historical cost basis adjusted for changes in the general price index since acquisition. Profit equals the difference between CPP revenue and CPP expenses, plus or minus net gains or losses on monetary items.[5]

2. *Replacement Cost (RC) basis:* Assets are valued on the basis of the current sacrifice which would be incurred in replacing the future service potential or capacity represented by the asset. Replacement values for all assets will have to be estimated by some method at the end of each accounting period. Profit, is the difference between realized revenues and the current cost of expense imputs adjusted by increases in the replacement cost of assets employed.

3. *Net Realisable Value (NRV) basis:* Assets are valued at their opportunity cost in terms of the current cash equivalent of the benefits obtainable in an orderly programme of asset disposal in current market conditions. Profit is equivalent to the change in the net worth of successive balance sheets (after accounting for capital introductions and withdrawals).

4. *Net Present Value (NPV) basis:* Assets or group of assets of the enterprise as a whole, are valued at the present value of the expected future stream of net cash flows atributable thereto, applying discount rates reflecting prime interest costs and risks. Profit, is equal to the change in the net worth of successive balance sheets (after accounting for capital introductions or withdrawals).

5. *Value to the Firm (VF) basis:* A combination of RC, NRV and NPV bases defined above.

Even a cursory glance at the above bases, should indicate to the amount of judgment that will have to be excercised in implementing the above methods to financial statements. Since many of the users of "Corporate Reports" will not be well-versed in accounting methods of valuation, such reports will have to remain a mystery for the unsophisticated users of annual reports and for the financial analysts, also.

So much effort and money is spent on developing these techniques of inflation accounting! The International Accounting Standards Committee (The IASC) has come with their "Proposed Statement" on "Accounting Treatment of Changing Prices"[6] which has a list of all the publications on the topic, of the member professional institutions. Reviewing most of these, one wonders about the chaos in valuation that might ensue from all the well-intended efforts.

Prof. Vancil of the Harvard Business School in the U.S.A., in his recent review of the several methods of inflation accounting,[7] suggests that the proposed methods could be grouped in four categories:

1. The Generally Accepted Accounting Principles (GAAP), the above mentioned Historical Cost basis of valuation.
2. The General Price Level Accounting (GPLA), the abovementioned CPP basis.
3. The Current Replacement Value Accounting (CRVA), a combination of the above-mentioned RC and NRV methods.
4. The Specific Price Level Accounting (SPLA), a method requiring asset values adjusted to changing price levels in each category of assets.[8]

From the view of usefulness to the users, Prof. Vancil favors the SPLA as "the best method of the four". By so doing, Prof. Vancil has added one more different basis of valuation, to the abovementioned others. However, the aim here is not to develop a thesis for or against any of the proposals. It is my belief that the "great controversy" has not ended. We shall be seeing new proposals and combinations of previous proposals,[9] until inflation, that unfortunate World disaster is ended. Although Prof. Vancil's recent proposal has no institutional supporter, all institutions related to Accounting Practices are continuing their efforts in trying to cope with the problem of the changing yard-stick, the money. Prof. Vancil nicely puts it, as follows:[10]

"The accountants of this World have recently began to worry a lot about that problem (inflation). Several alternative methods of "inflation accounting" have been proposed, and there is a raging controversy over which proposal is the best. While there is some risk that the accountants will exhaust themselves arguing and end up compromising on the status quo, there is even a greater risk that they will agree — on the wrong answer. If a fundamental change in accounting principles is adopted, it would have a major impact on the character of the information provided to *users* of financial statements. The choice, therefore, should be made by the users because they are the ones that will be affected. We have civilian control of the military establishment in this country because some decisions are too important to be left to the generals. In the case of inflation accounting, the impending decision is too important to be made by the accountants."

I am not that optimistic about future developments. Interest of the users to develop methods of inflation accounting may result in new proposals and different techniques which will add to the confusion. Simply because the concept of value is too general and you have to be very practical to reduce wide differences of controversy. And the problem will not find reasonable solutions until we did something about the value of our measuring stick, the money. Since, the root of the problem is in the changing value of money, can't we do something to stabilize it, instead of trying to change the Generally Accepted Accounting Principles? I know that this is a very traditional and conservative view. But are we not evading the basic problem, (the inflation) by trying to deal with the *effects* rather than the *causes* of the problem. I would like to conclude by a basic question that we accountants have to ask ourselves, many many times, before creating more confusion:

Why should not the Accounting Profession, with all their national and international powers and resources, concentrate their efforts towards stopping the International Disaster of Inflation?

It seems to me that the literature on "Social Responsibilities of Business Firms" and the idea of "Social Responsibility Audits" proposed recently have already challenged the Accounting Profession for expanding their total outlook to their role in Society. The theme of the coming Eleventh International Congress of Accountants[11] has been set as "The Accountant's Social Responsibility."[12] Is not one of the Social Responsibilities of Accountants to direct concentrated efforts aimed at stopping inflation?

REFERENCES

* Professor of Financial Accounting, Faculty of Business Administration, University of Istanbul, and President of the Expert Accountants Association of Turkey. Presently visiting professor at the Graduate School of Business of Stellenbosch University.

1 "Accounting for Inflation and other changes in price level", The Accounting Practice Committee of the National Council of Chartered Accountants (S.A.)

2 Methods to be defined subsequently.

3 Any basic accounting text will have excellent descriptins of the above methods of valuation. The author does not want to bother the reader with a long list of references.

4 "The Corporate Report", A discussion paper, Accounting Standards Steering Committee, The Institute of Chartered Accountants in England and Wales, London, July, 1975. pp. 66–72.

5 Ibid. p. 68.

6 At 3 St. Helen Place, London EC 3A 6CN. U.K.

7 Richard F. Vancil, "Inflation accounting. The Great Controversy", Harvard Business Review, March-April 1976. pp. 58–67.

8 The interested reader must refer to the above mentioned article of Prof. Vancil and to another one he recently published: "Funds-Flow Analysis During Inflation", Financial Analysts Journal, March-April, 1976 pp. 43–56.

9 Ibid. p. 43.

10 The USA Securities and Exchange Commission has recently come up with a new proposal. Please refer to: Sidney Davidson and Roman L. Weil, "Inflation Accounting: The SEC Proposal for Replacement Cost Disclosures", Financial Analysts Journal, March-April, 1976.

11 To convene in Munich in Oct. 10–14, 1977.

12 "Advance Programme", 11th International Congress of Accountants, Postfach 320580, Cecilienallee 36, D–400 Dusseldorf, West Germany.