CURRENT VALUE ACCOUNTING

A Practical Guide for Business

Edited by
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Preface

MOST of the published material on the subject of current value accounting has been written by and for academics and accountants, prompted by a natural professional interest in and a deep concern about the sometimes inadequate financial information produced by historical cost accounting in times of inflation.

But the businessperson—the nonfinancial executive involved in the day-to-day operation of a business enterprise—has often been excluded from this technical dialogue. For these operating managers there is, then, an urgent need for a text that sets out clearly all the issues, alternatives, advantages, and problems.

This book is the result of this need.

The editors wish to thank all the many people in Coopers & Lybrand offices around the world who have been involved in the mammoth task of researching and writing. In particular, we are grateful to Desmond B. Morin, the Canadian firm's National Director of Professional Development, for the stimulus he provided at the outset and for his invaluable advice as the project has matured; to Michael Charters, the Canadian firm's Director of Publishing, for his part in developing the original concept and for pulling the book into shape. Among the many others involved, we would also like to acknowledge the considerable help of our colleagues in the executive office in New York, Ronald J. Murray, Terry Aranoff, and Myra Cleary. Finally, we are indebted to our editors at the American Management Associations for their support and encouragement.

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The Changing Business Scene

> "The cause of lightning," Alice said very decidedly, for she felt quite certain about it, "is the thunder. No! No!" she hastily corrected herself. "I meant the other way about."
>
> "It's too late to correct it!" shouted the Red Queen. "When you have once said a thing, that fixes it, and you must take the consequences."

BUSINESSPEOPLE – whether they be owners, managers, or investors – have been hearing thunder and feeling the lightning strike for several years now. Rapid general inflation has raised many questions and led to considerable discussion about inflated or illusory profits, overcontrol of prices, overtaxation, dividend payments out of capital, a shortage of capital, and the true nature of a company's worth and profitability. In such a situation it is natural that the businessperson should turn to accounting, as the language of business, for explanations and solutions.

Measurement and analysis must precede any explanations, and the principal accounting tools and standards available to the business world for the interpretation of operating results have been those of historical cost accounting.

Historical cost accounting, founded on the premise that an asset should be stated at the actual amount paid for it (less depreciation and amortization), has traditionally not attempted to reflect rising prices due to inflation. While the rise was slow, the effect was rarely significant, and little concern was expressed over any disregard of inflation. Most analysts preferred to deal with the generally accepted accounting principles based on the familiar concept of historical costs. They feared that the judgments of managers and accountants required by current value concepts would lead to inconsistency of public financial reporting. As the rate of inflation increased, however, it became apparent that the distortions were growing too marked to be ignored, and concern arose over the adequacy of the allowances made for the effects of inflation.

In the balance sheet, the value to the business of assets purchased today must be reconciled with those purchased last year, or ten years ago, for far less money. Under historical cost, all are valued at their depreciated original cost. Similarly, liabilities are recorded in the amounts at which they were incurred. The ensuing confusion makes it difficult to judge the true financial position of a company, although it has been recognized for some time now that balance sheets cannot portray the worth of a company as a whole.

As for profits, these are traditionally measured, taxed, and distributed to shareholders by matching lower past costs against income from prices that have been forced rapidly upward by rising replacement costs. As a result, users of operating statements have difficulty in distinguishing between true and inflated profits.

Unlike Alice's abrupt change of mind, the initial accounting response has not been to turn the business world on its ear but rather to look for a solution within the framework of historical cost accounting. For instance, LIFO costing for inventories and general price level accounting, otherwise known as current purchasing power accounting, were introduced. Although each of these concepts has been able in some way to put the data derived from the historical cost framework into a better perspective, neither has been successful in providing a comprehensive solution. The anomalies remain.

Current value accounting is seen by many as the next logical step down the road. As Sir Francis Sandilands, chairman of the British government's Inflation Accounting Committee, has said, the process has been "evolutionary rather than revolutionary: no more than an extension in degree of principles already established in modern accounting conventions."

Yet, current value accounting attempts to tackle directly the crucial problems of gauging the value of a business and measuring profits during times of inflation (or deflation). In current value accounts, the balance sheet shows assets and liabilities at up-to-date values instead of historical costs. The single yardstick is what they are all worth now. Profit is calculated by charging against income not out-of-date historical costs but replacement costs for inventories or capital assets consumed.

The principles, although not yet completely settled, are relatively simple, but their application is bound to be complex and difficult. The purpose of this book is to examine in greater detail the reasons for considering current value accounting, evaluate its advantages and disadvantages, explain the practical problems of implementation, and look at the current status of inflation accounting in all the major industrial countries of the world.

In any business in any country, the important thing is that the system in use provide the information that is needed, whether by management, by investors, by employees, or by the public at large. Good management, as well as sound investment decisions, demands accurate, consistent, and pertinent information. Many accountants, analysts, and managers now believe that in times of even moderate inflation (or deflation), current value accounting is the best way of providing such information.

Nevertheless, businesspeople are understandably reluctant to cast off the lines from the steady mooring that historical cost accounting has provided and embark on a voyage in an uncharted sea. They contend, with good reason, that they can make the necessary adjustments for management decisions and that analysts and the efficient market do the same. In the United States, the recent requirement of the Securities and Exchange Commission for piecemeal replacement cost disclosure has added to the concern. It seems clear that in the United States, no move to displace the present framework (as is presently recommended in the United Kingdom and Australia) should proceed until current value accounting is understood and tried and the results are carefully evaluated as to their soundness, relevancy, and compatibility with present means of measurement. A step-by-step approach of this type has been adopted in Canada. The editors and authors of this book take no position in this regard, except to call for caution and understanding before proceeding.

Precisely where the future will take us is impossible to say with certainty. Current value accounting may present one answer to today's problems, but · ·w problems will demand fresh solutions. Undoubtedly the dial gue, of which this book is a part, will continue.

For today's managers and accountants the Red Queen's strictures are, fortunately, misplaced: it is not too late for change. In some instances, in fact, the culprits may turn out to be not those who change their minds but those who will not consider that possibility.

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The Threat of Inflation to Future Business Success

THIS book is written for the businessperson. Its purpose is to assist businesses to appraise their positions and direct their affairs as realistically as possible during a period of inflation that has threatened not only business success but often survival. As a general economic introduction, this chapter will take the reader on a preliminary random walk through the terrain as a whole.

A Malady That Is Sometimes Epidemic

Inflation is a vast subject. As a symptom of the instability that occasionally affects all societies it is at least as old as recorded history. As a social malady it is comparable to some diseases—always present and epidemic from time to time. Various aspects of inflation continue to be disputed among accountants, economists, and others. On one hand, there is general agreement as to the causes of inflation, as well as to the nature of the remedial policies open to governments during the early stages. On the other hand, there is less agreement about the most effective measures once inflation takes hold. This is in part because the remedies available to govern-

This chapter was written by Dr. Claude Isbister, a consulting partner in the Toronto office of Currie, Coopers & Lybrand, Ltd.

ments at later stages require more time to show any effect, and also because they are more likely to be met with resistance.

The very existence of inflationary conditions creates widespread expectations of worse to come: people fear that inflation will continue and even increase. Economists and governmental authorities have identified this aspect of inflation as being particularly dangerous. Countries and institutions can somehow adapt to the shocks and difficulties of government-imposed changes, even substantial ones, whose course is of limited duration, but they are threatened much more by the public psychology engendered by inflation.

A Socially Divisive Force

Everything about the future is normally shrouded in uncertainty. During inflation, however, uncertainty begins to operate independently and in turn becomes a major cause of inefficiencies and distortions. It foments the divisive forces that exist in every society, making it more difficult to reach agreement on anything. People are less willing than before to enter into contracts to deliver either goods or their own services at future dates at agreed prices. When they do, they try to protect themselves by charging more, and this accelerates price increases.

Inflation creates its own vested interests, and there are numerous conflicts between those who seem to benefit and those who are harmed. When the value of money deteriorates, debtors benefit at the expense of creditors, as homeowners with mortgages are well aware. The raising of prices and of money incomes provides governments with windfalls of tax revenues so that there is a shift of income away from the private sector. The loudest arguments against remedial public policies come from interested parties that fear the remedies even more than inflation itself.

No Sure Escape

The individual business encounters problems of strain and adjustment from the beginning of inflation. In the prevailing atmosphere of uncertainty, the individual firm expends more cost and effort on pricing than before. Cash flows are adversely affected while the costs of investment in assets increase. Tax burdens become more troublesome.

The questions about inflation are legion. What is it? Why does it pick up momentum at a particular time? Along what lines can governments and individuals agree on what to do about it? Can an individual conduct his or her affairs in such a way as to avoid the harmful consequences? The last of these questions is largely rhetorical, incidentally, for it may be said straightaway that there is no valid course by which the individual businessperson can prosper in such a situation. The problem is to find ways to minimize the damage and survive.

This is not to deny that there are some beneficiaries, but these tend to be fleet of foot, and few can plan in advance to benefit. Rather than learning how to cope with it individually, the best approach to inflation in any country is through public policies designed to control it.

Worldwide Inflation

An unsettling wave of inflation swept through most of the world during the past few years. It is too soon to discern whether or not its force is largely spent, but it appears to have subsided considerably. An overview of what occurred is provided by the statistics from selected industrialized countries in Table 1.

Table 1. Percentage increase in prices (measured by GNP deflator, estimates, and forecasts).

	Average 1959–60 to 1972–73	*1974*	*1975*	*1976*		*1977*	
				1st half	*2nd half*	*1st half*	*2nd half*
U.S.A.	3.0	9.7	9.3	4.3	5.2	5.4	5.7
Canada	3.5	14.3	10.8	9.9	7.8	7.0	6.4
Japan	5.3	20.3	7.1	5.7	7.6	6.7	5.9
EEC*	4.5	10.7	14.7	7.5	8.9	8.6	7.9
Germany	4.0	6.9	8.1	2.4	4.3	3.8	4.1
France†	4.7	11.1	14.0	9.1	8.2	8.4	8.2
United Kingdom†	4.7	12.9	27.4	10.8	9.5	10.1	9.0
Italy†	4.9	16.8	17.5	13.9	21.0	19.6	15.9
Seven major countries	3.9	11.8	10.8	5.9	6.9	6.7	6.5

* Sum of Germany, France, United Kingdom, and Italy.
† Gross Domestic Product.
Source: OECD, *Economic Outlook*.

Comprehensive changes in prices from one year to the next indicate that inflation exceeded an annual rate of 25 percent and peaked in the United Kingdom in the first half of 1975. The United States and Germany, each with its considerable industrial strengths, controlled their affairs with more restraint than others but were still affected, peaking in 1974 and 1975, respectively. In the second half of 1976, the indications were that price increases in the industrial countries were still at double the levels of the average increases from 1959 to 1973.

Inflation has been described as a situation in which too much money chases too few goods. Significantly, this in turn seems to have a further adverse effect on production of goods. The causes of this are complex. The surge of prices portrayed in Table 1, for example, appears to have been a leading cause of the depression of industrial production that ensued. The steepest annual increase of consumer prices in the United States was 11 percent in 1974, and this preceded a decrease of industrial production at the rate of about 12.8 percent in the first half of 1976. Although the process was less severe in Germany, the highest annual rate of increase of consumer prices in that country occurred early in 1973, following which industrial production dipped in 1974 and the first three quarters of 1975. Consumer prices increased in Japan by 22.6 percent in 1974, and industrial production fell sharply in that country at rates of 20.6 percent and 15 percent in the first and second quarters of 1976, respectively.

The course of industrial production in a number of selected countries is indicated in Table 2.

The developing countries were much more affected by this widespread process than were the industrialized countries. The shocks of inflation and recession were particularly damaging, for a time, in the poorest and most populous of them. Large increases in the prices of imports, reduced markets for exports, and shortages of capital were all severely felt in South Asia, in black Africa, and throughout Latin America.

In the Third World as a whole, price inflation was perhaps not much in excess of the inflation that occurred in the richer countries.* Because developing economies are thinner in structure and more fragile, however, they are more affected by such adverse circumstances.

* The author is indebted to Miss Patricia Macgowan and to the Economic Analysis and Projections Department of the World Bank for making available comprehensive and relevant data that underlie this conclusion.

Table 2. Industrial production (percentage changes from previous year).

	1973	*1974*	*1975*
Total OECD	9.3	2.5	−8.2
Canada	9.0	3.0	−4.7
U.S.A.	8.9	−0.3	−8.8
Japan	17.6	−2.3	−11.6
Germany	6.4	−1.3	−5.8
France	4.3	1.7	−9.0
Italy	9.6	4.3	−9.2
United Kingdom	7.4	−2.8	−4.9
EEC	8.0	0.3	−6.9
Netherlands	6.3	3.5	−5.3
Sweden	6.7	5.8	−1.7
Spain	15.1	9.1	−6.4
Australia	10.5	2.9	−7.3

Source: OECD, *Main Economic Indicators.*

This frustrating and destructive period can be analyzed—though not entirely explained—as an escalation of the demands of consumers for increased amounts of goods and services beyond the capacities of production mechanisms to satisfy the demands. In economically more advanced countries, the acceleration of inflation appears to have been initiated mostly by governmental spending in the public sector and by excessive monetary growth. The governments, in turn, were responding in various ways to public desires. The timing and extent of governmental responses, whether they were open-handed or more austere, appear to have played an important part in each case.

OPEC Participation

With inflation already under way, the OPEC cartel was able to raise the world price of petroleum by the end of 1973 to four times the level of 1972. The petroleum producers thus obtained a substantial increase in their share of the world's goods, and this implied a smaller share for others. In retrospect, it appears that while the significance of this was appreciated in some countries, it was insufficiently understood in most.

The shift of economic power to the oil producers was not so large as necessarily to be ruinous to the rest of the world. It was so sudden, however, that it caused discomfort and required difficult adjustments. In addition to the transfers of income and wealth, there were three other areas of economic consequence: first, a dramatic change in relative prices, led by those of energy; second, additional inflation; and third, impacts on monetary flows.

These burdens were distributed unevenly and hit some more than others. Strong, industrialized countries such as the United States, Germany, and Japan had enough fiscal stamina and were able to make the necessary adjustments that would allow progress to be resumed. One way or another, these countries seem to have sensed that domestic production was an essential part of their response to OPEC. They had the ability to produce, and they pursued economic policies that allowed them to exploit their potentials. With recent trends, even some of these countries are facing renewed uncertainties, but thanks to their initial response, they are better positioned to maintain their production levels than they would otherwise have been.

For a variety of reasons, other countries did not fare as well. These included many that avoided adjusting to the new circumstances, at the same time neglecting the vital areas of money supply and production. Where the major economic initiatives consisted of borrowing and financing to support consumption, there was a tendency to frustrate production and prolong inflation, whatever other priorities were being served.

International Exchanges

Between 1969 and 1973, prices were relatively more stable, but this period saw major realignments of exchange rates. The U.S. economy was overextended, in part because of the effort made to finance the war in Vietnam while maintaining domestic expenditures. The U.S. dollar was then found to be overvalued in relation to the currencies of several economies that were relatively strong at the time. During the four years up to and including 1973, the French franc appreciated by 17 percent, the German mark by 48 percent, the Swiss franc by 37 percent, and the Japanese yen by 33 percent in relation to the U.S. dollar. Exchange rate adjustments, some of them quite notable, continued to take place during the inflation and recession that followed 1973. From 1973 to October 1976, for example, the British pound declined by 32 percent in relation to the U.S. dollar, whereas the Swiss franc appreciated by 29

Table 3. Average spot rates against U.S. dollars (U.S. dollars per unit).

	British Pound	*Canadian Dollar*	*French Franc*	*German Mark*	*Swiss Franc*	*Japanese Yen*
1969	2.39	.93	.193	.255	.232	.00279
1973	2.45	1.00	.225	.378	.317	.00370
1974	2.34	1.02	.209	.386	.336	.00343
1975	2.22	.98	.234	.407	.387	.00337
1976	1.81	1.01	.210	.398	.400	.00337
1977*	1.72	.95	.201	.419	.393	.00364

* For period up to April 6.

percent. With some conspicuous exceptions, exchange rates in general did not fluctuate by percentages as large as in the preceding period. At the same time, the difficulties and tensions of domestic economies were accompanied by continuing turbulence of the exchange. These trends are illustrated by Table 3, which shows average spot rates of exchange against the U.S. dollar for the currencies of six of the industrialized countries.

The Economic Impact

To play billiards on a ship at sea is to turn a game of skill into a game of chance. So it is with trying to plan and operate a business during severe inflation. It becomes difficult or impossible to foresee the future or even the consequences of one's immediate actions in any meaningful way.

One of the major problems for effective planning is that during inflationary periods, interest rates must generally be higher to take account of the diminishing value of money. If prices are being inflated at 10 percent per year, a lender requires interest at least at that level to avoid erosion of its capital. Depending on the term of the loan and the creditworthiness of the borrower, interest rates in the capital markets tend to be higher than the current rate of inflation, whatever this is. Lenders and borrowers quickly learn that a high nominal rate of interest may correspond to a low "real" rate. For instance, if the nominal rate is 14 percent and the rate of inflation is 12 percent, the real rate is only 2 percent.

There are times, incidentally, when interest rates fail to keep up with inflation. When this happens, portfolio managers and trustees may find that there is no way to invest capital prudently and maintain its value.