Mallinson

Understanding current cost accounting

A Guide for those preparing and using financial statements

Butterworths

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by

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Preface

Sensationalism is ultimately self-defeating, and it is probably not an exaggerated claim that the development of inflation accounting, marked in the UK by the recently issued Accounting Standard (SSAP 16), is the biggest event in accounting in living memory. It would be a mistake to regard the accounting requirements of SSAP 16 as another instance of tinkering with the mechanism—irksome or helpful—according to one's point of view. Rather, SSAP 16 marks a new beginning; from now on, the results and well-being of businesses will be measured by a different yardstick, as if the coinage, or the currency itself, had been changed. There will be little means of escape; even for businesses presently exempted by the size criterion the skilled observer will be able to effect his own translation of conventional figures.

The accounting standard itself emphasises the evolutionary nature of the subject. After one or two false starts a practical beginning was achieved with the introduction of the Hyde Guidelines, and the experience of companies experimenting along these lines has doubtless convinced the Accounting Standards Committee that the practicality of the Guidelines may be put to wider effect. Indeed, the accounting standard largely encompasses the Hyde Guidelines, refined to deal with the monetary problem and extended to provide a link between CCA profit and loss account information and related net assets statements.

There are many who would prefer to await the development of a more grandiose edifice, a more complete job. To them, the reply must be that the complete job that they require is but a vision probably far beyond our immediate grasp, because the object of our search reaches down to the very fundamentals of accounting.

At the beginning of the 1970s it was possible to debate the question "What is profit?" as the theme of a Summer Course organised by the English Institute of Chartered Accountants with scarcely a murmur about inflation. Asked that question today, the accountant would have to consider the nature of the capital structure, or corpus, of the business that is to be maintained before striking profit. Do we arrive at profit after keeping intact the funds invested in a business, knowing that those funds will need to be augmented as prices rise, or do we measure profit after maintaining the assets in which the funds are invested—what SSAP 16 terms the "net operating assets"? In the one case, the measurements are calibrated in yesterday's costs; in the other, in today's.

Indeed, the considerations that now arise from that basic question are even more far reaching, and penetrate to the purpose of accounting itself. Has a business a different perception of profit from that of its owners? What constitutes a business? To whom, and in what form, is a business accountable in a financial sense? These are the fundamental issues raised by the concept of accounting for the effects of changing prices on a business by measuring in current cost terms.

Whether we like it or not, there is no going back to that earlier era, short of a restoration of the integrity of the currency. The more fundamental issues in accounting will not be suppressed by attempts to improve the existing model, useful though the improvements might be in themselves. Questions will be asked, and measurements will be made in current cost terms. The new medium has been absorbed into the language, as any financial newspaper or journal will show. It was a forgivable mistake to try initially to oust the existing historical cost yardstick, but the availability of a different yardstick is now widely recognised. CCA is here to stay, even if at this stage it lacks the streamlining of the age.

The financial reporting media have done much in the last few years to lend substance to the assertions often made by the UK accounting authorities during the past thirty years that conventional historical cost accounts were an insecure foundation or were even misleading in an inflationary environment. Nevertheless, there remains widespread misunderstanding of the new measurements, and much distrust of the methods, particularly by the accounting profession itself. Conventional accounts are used as it were to prop up the new figures. Despite the plethora of explanations, or perhaps because of them, there remains an air of mystery surrounding any form of inflation accounting, almost like that appertaining to inflation itself. Have we not learned to live with the phenomenon, it is claimed, except perhaps for the businesses that have vanished into bankruptcy or have become state-aided?

This book is an endeavour to explain the aims of CCA and the effects of its measurements, not as an appendage to conventional accounts but as a measuring and reporting medium in its own right. Mastery of a new language requires an ability to think in that language, and it is probable that much of the confusion that is attributed today to the intrusion of CCA derives from attempts to think in historical costs and to articulate in current costs. The author believes that so fundamental a change in accounting philosophy cannot be satisfactorily accomplished by a brief statement of a mandatory accounting standard and by devising a do-it-yourself type check-list.

SSAP 16 and its related Guidance Notes feature prominently in the book and are reproduced as Appendices I and II by kind permission of The Institute of Chartered Accountants in England and Wales and The Accounting Standards Committee.

The first part of the book, embracing Chapters 1 to 6, begins, after an introductory chapter, with an outline of the deficiencies of conventional measurements in relation to the accounts for the last decade of UK industrial and commercial companies as a whole. It then goes on to examine the integrity of the CCA yardstick, to interpret accounts prepared by that yardstick, to examine the fidelity of the underlying notion of capital maintenance and related profit and to explain the effects of changing prices on the monetary working capital of a business and to test the strength of the accounting standard on this issue.

The second part (Chapters 7–11) looks in detail at the specific adjustments that are needed under SSAP 16 in order to apply the new yardstick. The approach has been to examine different routes by which CCA might be implemented in various business circumstances, to explain the nature and effects of the adjustments, to propose solutions to particular practical problems, and generally to help the reader to work out his or her own approach to implementation. It is emphasised that the book is intended to be read in conjunction with SSAP 16 and the related Guidance Notes.

Emphasis has been given in this part of the book to techniques for estimating the effects of inflation not only as an aid to management in policy formulation but also as a determinant of the methods to be followed by the accountant in the application of CCA. For instance, Chapter 8 contains a table based on statistics provided by the Central

Statistical Office (Price index numbers for Current Cost Accounting, HMSO) comparing the rates of price changes of fixed assets used by specified industries during the last ten and five years respectively, while Chapters 9 and 10 contain illustrations showing how the effects of inflation on stocks and net monetary working capital might be estimated.

It is bordering on the presumptuous for an author to advise on the reading of his book. While an interdependability was intended throughout, readers who want a thumb-nail sketch of the inflation accounting problem may find their needs satisfied by Chapter 1. This chapter was intended as an overview, or microcosm, of the book as a whole. Readers concerned with the interpretation of accounts prepared under CCA measurements, or in thinking in the new language, may concentrate primarily on the first part, while readers faced with the task of implementation may find the second part to be more closely directed to their needs.

It is true that no man is an island, and countless people have contributed to the writing of this book. Memories remain vivid of the spark induced by Drs W van Bruinessen in his address, "Bases of Accounting other than historical cost" given at the Tenth International Congress of Accountants in 1972, and of a visit made in April 1975 to the fount of current cost accounting, Philips of Eindhoven. A particular debt of gratitude is owed to my colleagues in Price Waterhouse & Co. Credit that the book has seen the light of day must be given to Graham Stacy, Director of Technical Services, whose enthusiasm for the project and for the subject itself often revived a flagging spirit and urged completion of manuscripts that might otherwise have found oblivion. Ian Smeaton has stage-managed the proof-reading with aplomb and indefatigability, Nicole Blakey has for years conjured up articles from the four corners of the earth seemingly by next day's post, and secretaries have toiled uncomplainingly with unreadable manuscripts. My benefactors also include the many persons, companies and institutions who have kindly consented to my use of material quoted or referred to in the text. Last but not least thanks must be given to my wife and daughter who have borne this stranger in their midst with a stoicism that became even more evident as it departed.

DEREK MALLINSON
April 1980

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