FINANCIAL REPORTING UNDER INFLATIONARY CONDITIONS

by Drs. I. Kleerekoper

Mr Chairman,
On the occasion of the First Jerusalem Conference on Accountancy it was a great privilege to have been invited to prepare a paper on „Accounting and auditing problems of International Enterprises". Unfortunately, in 1971 a sad event at the last minute prevented me from coming and delivering my paper personally. But when I asked, my colleague Aad Tempelaar he immediately expressed his willingness to read the lecture at that conference, for which I was and still am very grateful, and I am glad to be able to take this opportunity to say so, in his presence, today. It is self-evident that I feel extremely honoured by being invited a second time, now to act as a Conference reporter, and I am most grateful to be here, in Jerusalem, and to be able to address you all.

I consider it to be another privilege to present my report under the chairmanship of Mr Fred Somekh. We all undoubtedly remember Mr Somekh's many representations of the Israeli profession at different international congresses and conferences on accountancy, of which the most recent and for me the most impressive was his being an International Commentator on the subject of „Bases of accounting other than historical cost" at the 10th International Congress of 1972 in Sydney, Australia. On that occasion Mr Somekh began his address by referring to inflation as an erosion of the value of the monetary unit; in doing so he could - in 1972 - still rightly describe inflation as showing a „creeping" pace in the highly developed economics! And now, only two years later, we know how much the scene has changed; the „creeping" is over, unfortunately.

The contents of the excellent national papers on the subject of „Financial reporting under inflationary conditions: trends and prospects" make it quite clear that - under the present accelerating inflationary conditions, the so-called „double digit" inflation - the problem of how to report financial position and results of operations of a business entity in a meaningful manner is given full attention almost everywhere in the world. I would say that there is scarcely a country of any importance where economists, financial analysts, public accountants and other interested parties do not from time to time rush to their pens or climb platforms, in order to convince their audiences of the absurdity of comparing - and still worse the absurdity of adding together - amounts expressed in historical American dollars or English pounds or Argentinian pesos or German marks or French francs or even Dutch guilders; being national currencies each of which has an ever diminishing unit value. At the same time one can observe an impressive activity of Boards, Committees and other Bodies in this field, such as the F.A.S.B. (the Financial Accounting Standards Board, the 1973 American successor of the Accounting Principles Board), the A.S.S.C. (the Accounting Standards Steering Committee of the Institute of Chartered Accountants in England and Wales and of four associated accountancy bodies in the United

Kingdom), followed by the Sandilands Committee (a United Kingdom Government Committee), the I.A.S.C. (the International Accounting Standards Committee, sponsored by accountancy bodies of many countries) and so on. They all concentrate, among other things, on „inflation accounting" or similar subjects. But so far, only one of these bodies, the British A.S.S.C., has come into the limelight with a statement, its famous Exposure Draft 8, dated January 1973, which after much discussion in May 1974, was followed by a Provisional Statement (S.S.A.P. nr 7). The other Boards and Committees, previously mentioned, are still in the process of studying and preparation; as regards the results of these studies and preparations we have to be content to „wait and see".

Perhaps our Argentinian colleague Mr Gak would like to comment that so far, the South American efforts in this respect have not been given full credit. In his paper he reports on the much earlier and stronger inflation there and on the pronouncements made by professional conferences and bodies during the last decade. It is true that there is a growing awareness of the necessity to adopt methods of accounting which reflect the influence of inflation on financial positions and results of operations of business entities. It is only remarkable that inflation had to become „double digit" before the accounting profession began to move, even though - as my compatriot Mr Bak describes in his paper - on the occasion of many international congresses particularly the Dutch authors have tried to convince their foreign colleagues of the necessity of not sticking to historical cost.

Looking back at the attitudes of the accountants in different countries Mr Hyde reported concerning the United Kingdom that: „It is easy to see why accountants should accept the concept of unchanging units. The arithmetical accuracy of a trial balance is dependent upon last year's figures brought forward being exactly equal in effect to this year's". Mr Soberman says about Canada: „Indeed, until not too many years ago the alternatives to accounting based on historical costs, which had been proposed by accountants in the academic world, and in a few noteworthy cases actually implemented by some innovative Canadian companies, were for the most part almost ignored by the vast majority of public accountants in Canada". And somewhere else in his paper Mr Soberman states: „In the case of the accounting profession in Canada, I believe that a great deal of its resistance stems from a lack of understanding of the relevant concepts on the part of a large percentage of its members". Mr Bawley states that the Israeli Institute is in arrears as it has not yet taken a conclusive stand on the question, notwithstanding the current steep rate of inflation.

Mr Wyatt, in his paper which considers the United States history and situation, said „. . . the inflation rates in the latter part of 1973 and first half of 1974 exceeded 10%. The term „double digit" inflation has come into popular usage. As a result, businessmen, economists, and *even* many accountants have expressed their interest in identifying and measuring the effects of inflation. The Securities and Exchange Commission recommended in late 1973 that companies disclose the element of inflation profits in inventories. Few companies made such a disclosure, possibly because the notion of inflation profits in inventory is unclear". When discussing the status of fair value accounting Mr Wyatt continues: ,,. . . fair value accounting had received even less attention by the accounting profession in the United States than had price level accounting". Mr Wyatt reminds his readers of the A.P.B. research studies nr 1 and 3, indicating that current valuations for assets of an enterprise were more useful to financial statement users than historical cost valuations. In his opinion the lack of reaction to these research studies was the result of ,,the absence of any agreed upon objectives of financial statements".

There is no reason to disagree with Mr Wyatt, but it is my feeling that this diagnosis shows only part of the disease. The deeper roots of it are to be found, I believe in the way the average accountants were and still are educated in the United States and in many other countries. Too much, if not nearly all, emphasis is given to the teaching of accounting and auditing techniques producing very able and highly skilled accounting and/or auditing technicians, but too little, if not hardly any, attention is devoted to economics and more specifically business economics. As long as the majority of the practicing accountants do not understand the nature of the economic processes within the business enterprise and therefore are not able to recognize accounting as the measurement of values being relevant to everybody who has to make judgements and take decisions on the basis of them, there will be the kind of lack of support Mr Wyatt and other authors have pointed out.

The matter of education being too one-sided or too limited is not a new issue. I may refer to the United States Beamer Report entitled ,,Horizons for a profession" (1966) and the British Solomons Report (1974), the latter defending its proposals for a different education with the words: ,,that it should make the prospective accountant a more professional man, less likely to slip into the rut of just using well tried methods". Here we are back at the problem of the first two sessions of yesterday.

So, if we want accountants to be more receptive to an economic approach to accounting, we should improve their education by requiring a thorough business economic foundation for accounting techniques and methods. I have already emphasized the necessity of an economic approach to accounting in my paper submitted to the 8th International Congress of Accountants in September 1962 in New York. In that paper I explained that the objectives of business entities are economic in nature; each business operates between markets, obtaining goods and services from the buying market (including the labour market) and disposing of goods and services on the selling market. It normally does this with a view to making a profit. Within this economic frame-work the management of every business entity must make a choice between the alternative possibilities; its principle task is to ascertain and weigh the alternatives and then to make a decision. From case to case the guide in chosing should be the difference between the proceeds to be obtained and the sacrifices to be made. Thus it is a matter of economic decisions, for which information with an economic content both quantitative and qualitative must be available. Consequently, it is economic science and in particular the theory of business economics which should provide the foundation on which accounting must be built, in order to obtain the information that is indispensable for making rational economic decisions and controlling the activities. In other words the postulates of accounting must in the first place be based on the achievements of the science of business economics.

This quotation from my paper of 12 years ago can still be seen today as the underlining of the necessity to adapt the education of accountants to the requirements of an economic approach to accounting.

The question arises whether the strengthening of the economic foundation of the accountants' education would prove to be sufficient for achieving an adequate response to systems other than historical cost. The reply to this question is: ,,not necessarily". What we should also fight against, is the danger of the profession and its education developing in a too legally oriented direction; a condition existing in countries where accounting is rigidly regulated by company law. The effects of this can be clearly demonstrated by comparing two countries which are geographically close together and show a rather different picture; that is West-Germany and The Netherlands. From Mr Niehus' paper we learn - also Van Bruinessen referred to it yesterday - that even in the twenties such famous theorists as Schmalenbach and particularly Schmidt were indicating the direction towards substantialistic as against nominalistic valuation and accounting. In The Netherlands it was Limperg who did the same by developing the theory and system of replacement value. Remarkably, however, Niehus states ,,in practice we (i.e. the Germans) have not been able to implement their ideas and, even less, to proceed beyond them", whereas the Dutchman Bak is in a position to say, that the concept of the replacement value theory and the application of current values in the annual accounts of companies ,,to a great extent determine the trends and prospects in financial reporting under inflationary conditions in my country much more so than do price level or inflation accounting". ,,The Dutch accountant's perspective on proposals such as inflation accounting and his way of discussing them are conditioned by nearly fifty years of theory and practice of accounting methods not based on historical costs".

The explanation for such a different development between the two countries is mainly to be found in the difference in legislation on company law. From the beginning, company law in Germany has been very detailed, not only with regard to format and specification of the financial statements but also to valuation. The ,,Mark is equal to Mark" principle has not only been enacted for tax purposes but also for the preparation of annual accounts and financial statements. On the other hand in The Netherlands, until only a few years ago, there existed hardly any statutory regulations on format and content of annual accounts of companies. It is evident that the atmosphere of not having statutory regulations has strongly stimulated the development of accounting theory in general and current value accounting in particular. Furthermore, the recent Dutch law on the annual accounts of companies fortunately does not contain any valuation regulations. Consequently, also in the present situation under the existing law on the annual accounts, companies are free to use valuation bases other than historical cost; the only requirement is that the system should be clearly disclosed and explained and should comply with the concept of a true and fair view of the company's financial position and results. I may refer here to the paper of my partner Van Bruinessen on the subject of Accounting Standards and Rules. The German situation however proves that the existence of very detailed regulations can lead to rather legally oriented accountants, for whom it is difficult to keep an open mind to new developments in the field of accounting and valuation. From that point of view I have to admit that I am not very happy with the developments in the European Economic Community, and particularly the fourth directive, which is driving in the direction of very detailed statutory regulations. It required quite a fight to achieve what will be a virtual acceptance of valuation bases other than that of historical cost, but this can only be done providing the main figures, based on historical cost, are also disclosed as comparitives.

So far I have discussed two important reasons why the accountancy profession in general did not react satisfactorily to proposals or ideas to present an alternative to historical cost accounting; these reasons were in the first place the insufficient education of professional accountants in the field of economics and particularly business economics *and* secondly the existence of detailed statutory regulations on annual accounts.

A third reason can be found in the taxation aspect. In many countries we find regulations which allow „lifo'' inventory valuation; investment tax credits and accelerated depreciation for fixed assets. The motivation for these regulations was not normally as a mitigation of the effects of inflation, but generally served the purpose of stimulating economic activity, when necessary or desirable. However, there is a firm reluctance, if not a complete refusal by governments and tax authorities to accept some form of inflation accounting or current value accounting for taxation purposes. Many of the national authors point out that the rate of taxation on real profits is in fact much higher than the governments and tax authorities pretend to levy on profits calculated on the basis of historical cost. It is a fact of life, that the reluctance or refusal to accept some form of inflation accounting for taxation purposes, at the same time appears to be an impediment to accepting it for financial corporate accounting. Mr Niehus tells us that the suggestions of the German accounting profession to include the possibility of forming a replacement reserve in the company law reform of the 1950's, was refused by parliament because of its effect on tax revenue. He continues: „Instead, the company law now permits the retention of part of the after tax profit''. Niehus is an optimist, when he adds: „This provision, no doubt, is one of the corner stones of inflationary accounting in Germany''. I think it unrealistic to expect the governments and taxation authorities to accept any form of inflation accounting or current value reporting prior to its general adoption by business life and the accountancy profession for external financial reporting. Again referring to The Netherlands, it is normal practice that annual accounts for financial reporting and for taxation are drawn separately along different lines, applying different valuation bases. In doing so, taxation regulations do not form too much of an impediment to the acceptance of current value accounting and similar systems for financial reporting purposes. In my opinion it should be the task of the accountancy profession to stimulate the application of advanced accounting principles even when these principles have not, or have not yet been accepted by the tax authorities.

When reviewing the papers of the national authors, as well as yesterday's oral introductions, it is evident that financial reporting under inflationary conditions can only be adequately done when accepting the departure from historical cost accounting. Roughly speaking two directions are described and from time to time defended by the national authors; one direction can be referred to as inflation accounting, the other direction as current value accounting.

It would not be very useful to enter into a detailed description of these two methods at this time. I assume that most of my audience have already had the opportunity to read the national papers and if they have not, they will undoubtedly find that opportunity afterwards. I feel more inclined to reconciliate the standpoints of the national authors with regard to their pros and cons vis à vis inflation accounting and current value accounting. To this end I will now quote from their papers some statements, being - in my eyes - characteristic for their attitude towards the two systems under consideration.

Mr Hyde of the United Kingdom considers that arriving at the replacement costs might be done by estimating current market values or by applying particular price indices for classes of assets. He adds: „There is therefore scope for discretion and subjective judgement". Mr Hyde believes that for Management Accounts this is a good thing because the method appropriate to the particular problem under review can then be used. He continues by saying that it is, however, not considered suitable for published accounts where the virtue of consistency is so strongly desirable. If subjective judgement is a major factor in producing a published statement the auditor cannot agree with the result in the same way that he can with a more rigid method. Consequently, Mr Hyde prefers the usage of current purchasing power methods, which fall under what I called the system of inflation accounting.

Mr Soberman of Canada begins by saying that general price level adjustments have the advantage of relative ease and objectivity. Current value accounting however is quite subjective in the methods used and will generally require a great deal of time and effort to be employed. He continues: „Although some might argue that in the long run there is reasonably close correlation between changes in general price levels and the values of specific assets, recent experience in Canada has shown this assumption to be of questionable validity". Mr Soberman then concludes this part of his paper by saying that obviously in many instances current value accounting would be far more meaningful than general price level adjustments.

The following is the opinion of Mr Wyatt of the United States: „Accountants and others interested in financial affairs must recognize that only through current value data can financial statement users make the judgements for which they rely on financial statements. Current value data is not without its practical hurdles to overcome, but financial information presented on any other basis is as likely to mislead as inform. In periods of inflation this likelihood simply increases".

Mr Gak from Argentina gives full credit to the detailed system of inflation accounting adopted by the professional bodies in his country, whereas Mr Niehus from Germany just describes the state of affairs in Germany without taking a personal standpoint, which he amended yesterday by expressing a personal preference to replacement value accounting.

Mr Bawly's position seems not quite clear. In his opinion a current price system, incorporating both annual inflation rates and currency fluctuations is a primary requirement if financial operations are to be presented fairly. He adds: „Just what form that system should take is a much more complicated problem . . .". He then continues: „In the future, presentation of operating results will be much less uniform than it has been. Greater emphasis will have to be given to the method by which the company controllers and accountants reached the figures presented in the financial statements".

My compatriot Mr Bak explains that - for a Dutchman - it is impossible to enter into discussions on the topic under review without being strongly influenced by nearly fifty years of theory and practice of accounting methods not based on historical costs in The Netherlands. When referring to recent Dutch developments in the theory of replacement or current value, he demonstrates in a very clear schedule how the profit and loss account can be analysed in components which can be treated differently under different profit conceptions. Mr Bak, when summarizing these developments, states - and he repeated his statement yesterday with much emphasis - that the use of current value is recommended because it improves the quality of the information provided on „transactions" and „holdings" by segregating the two; and that the use of current value does not dictate a specific profit concept. When comparing the current value system with the British inflation accounting system Mr Bak begins by referring to the wide-spread feeling that something must be done as soon as possible and that in this perspective the publication of S.S.A.P. 7 should be welcomed as „doing something" without necessitating any changes in the basic annual accounts. As a disadvantage of the system Mr Bak mentions that it does not provide for an adequate and perpetual record of changes in equity. For his further remarks regarding the use of the general index in connection with the „convention of prudence", introduced by paragraph 21 of the Standard, I may refer you to the contents of his very interesting paper.

I feel inclined to agree with Mr Bak that, irrespective of my ultimate preference for one system over an other, it should be welcomed that in the United Kingdom a start has been made by the issuance of S.S.A.P. 7, giving us the feeling that at least something is going to be done to correct the inflated profit-figures resulting from the application of the historical cost convention. It is with great interest that we will wait and see whether, and to what degree, the recommendations of S.S.A.P. nr 7 will be followed and whether quoted companies will produce supplementary statements amending the accounts to a current purchasing power basis. Mr Wyatt believes that the most likely prospect in the United States is that the F.A.S.B. will issue a statement of accounting standards that will require supplementary reporting of financial information adjusted for the effects of general price level changes. In his opinion a far less likely prospect is that this supplementary information will replace the historical cost based data in the foreseeable future. The I.A.S.C. just published an exposure draft containing a proposed statement on the valuation and presentation of inventories in the context of the historical cost system; it is no secret that this proposed statement came into being on the condition that a separate study will be made of the application of systems other than historical cost. What I am deeply afraid of is that inflation accounting - or in other words current purchasing power accounting - will become the generally accepted remedy to historical cost accounting and that the chances of a more meaningful method being widely accepted, such as some form of current value accounting, will be small if not non-existent. This fear is caused and strengthened by the fact that in defending inflation accounting and attacking current value accounting a number of arguments are used which are indeed very weak if not incorrect. One famous argument against current value accounting is that this system is based on a number of estimates and subjective judgements. We have to take into account that estimates and subjective judgements are inevitable elements of any accounting method; the estimated useful life of buildings, machinery and equipment as a basis for depreciation, the degree of obsolescence of classes or items in inventories and their net realisable values (to be applied if lower than cost), the degree of collectability of accounts receivable, the adequacy of provisions particularly for contingencies, etc.; they are all subject to estimates and subjective judgements. In this respect the market price of a commodity, the offering price of an item of equipment and the index of construction prices - serving as basis for current values - are certainly to a lesser degree estimates and subjective judgements than the examples I gave before. But even in the few cases where no hard prices or specific index figures are available, a system of ascertaining current values can be developed, offering a sufficient basis to the auditor to enable him to form a professional opinion. This is not merely a theoretical statement, but a statement based on practice and experience in this field in our country. Another argument against current value accounting is that current values may be interesting for management accounts, but that they are not considered suitable for published accounts where the virtue of consistency is so desirable. This argument rests on a misinterpretation of the concept of consistency. It is not difficult to prove that comparing historical cost data is one of the most inconsistent things to do, which could only be improved by inflation accounting, if and when the movement of the specific prices of the various assets and that of the general price level index appear to run parallel to each other, which is rarely the case. Moreover, in my opinion, the creation of a contrast between management accounting and financial report accounting should be rejected. I had already written in my 1962 paper, which I mentioned before: „The postulates of accounting must, in the first place, be based on the achievements of the science of business economics. Since these achievements are the result of deductive reasoning and have been set on the proof of practice, they will not only be useful but above all normative. Thus, they provide a more effective foundation for their acceptance as principles of accounting than is the case now. From this basis such a unity of conception can result that no scope will be left for starting points varying with the separate spheres of accounting that at present can still often be distinguished, such as management accounting and ownership accounting. Since all parties interested in the business are primarily concerned with its economic objectives, there is no sound reason for a difference in postulates and/or principles; both management and owners require information of a similar qualitative content; their requirements only differ in detail and frequency." This somewhat lengthy quotation of what I said in 1962 is undoubtedly also true today. It is in my opinion one of the big disadvantages of the system of inflation accounting, that it does not open the possibility of a permanent and continuous registration of relevant values, relevant for decision making as well as for reporting, such as an integrated perpetual system of current accounting does, but that it can only be applied for reporting purposes at the end of a reporting period. This disadvantage makes the system of inflation accounting (or current purchasing power accounting) an artificial means of restating figures which are basically incorrect. For this reason we need not reject the system immediately, but what we should do is realize that it has only a limited significance and that it should be considered as a temporary bridging of the gap between historical cost accounting and current value accounting. On the other hand I am fully aware that in using the concept of current value accounting, I am very much simplifying the matter by not defining its contents more in detail. I shall nevertheless refrain from doing so, because I fear that otherwise I could confuse you too much by becoming too specific. It is very convenient that I can again refer to the excellent paper of my compatriot Mr Bak where he mentions in his introduction a number of papers in the English language presented by Dutch authors at international congresses since 1952 and where he reports on recent developments in current value theory during the last decade in his and therefore also my country.

If we consider the prospects of financial reporting under inflationary conditions we can only be certain that this problem is and will remain in the focus of business life, governmental agencies and the accounting profession. Moreover it seems most probable that a system of current purchasing power accounting will be widely recommended, if not prescribed, in the form of a supplementary statement alongside the historical cost figures. If and to what extent more meaningful accounting methods will be recommended and here and there required is probably to a large extent dependent on the contribution to be given by the accounting profession. As explained before, our profession can only be an element of importance in the furthering of more meaningful and sophisticated accounting theory and policies, if we furnish it with an adequate portion of economic and business economic education, also post-graduate, as part of a system of permanent education! It is impossible to require a profession of technicians, how ever highly skilled they are, to have an economic approach to accounting if this approach is beyond their conceptional possibilities. Furthermore the profession should, where possible, be firmly opposed to statutory regulations in which the system of valuation is rigidly prescribed, in order to avoid a situation in which the application of new concepts and methods will be forstalled, thereby killing every initiative to innovate existing accounting conventions. Whether or not in these cases, for the sake of comparison, some reconciliation with another valuation system should be required, remains an open question, to which I can only add my doubts as to whether too much emphasis is laid on the requirement of comparability, taking into account that economic life shows such a variety of phenomena that it is very difficult to imagine that it can all be expressed in terms of one denominator. But - unfortunately - the matter of comparability appears to be very important in one dramatic aspect. I now refer to the fact that - as Mr Bak already reported and Prof. Small yesterday referred to also - some Dutch international companies are reverting to the use of historical costs in order to gain comparability in the international capital markets. We have to take into account that companies, who present their financial statements on the basis of current value accounting, normally show a high stockholders' equity and a low income, as compared with similar companies, accounting on a historical cost basis. That means that the „return-on-investment-ratio" of the former companies seems to be much more unfavourable than that of the latter. It does not help the current value company very much to know, that all these historical cost companies present meaningless figures, as long as the readers and users of financial statements do not agree and arrive at incorrect conclusions. It is therefore necessary that the international scene shall change quickly and that current cost accounting shall gain international application, in order to avoid more current value users to feel forced towards the wrong system of historical costs, only for the sake of comparability! It is a poor consolation that price level accounting may then be applied more widely.

Financial reporting under inflationary conditions is obviously only a problem as long as inflationary conditions remain in existence. It would be far more pleasant if we could, instead of solving the problem of financial reporting, solve the problem of inflation. Although I am not very optimistic, I nevertheless sincerely hope that a fundamental cooperation between states and nations, as well as between government, industry and labour unions, may have the effect of a diminishing and if possible eliminating inflation.

We accountants will not be unhappy if the subject of financial reporting under inflationary conditions will disappear from the agendas of international and national meetings. But please do not feel relieved too soon; current value accounting has basicly nothing to do with inflation. It is concerned with specific price movements of specific goods and its influence on financial positions and results of operations; it is improving the quality of information by accounting separately for the results on „transactions" and on „holdings"; even if there is no inflation at all. For this reason I cannot offer you any relief with regard to the never failing persistence, particularly of my Dutch colleagues, on the topic of what we originally called replacement value and nowadays often refer to as current value accounting; not even if inflation is successfully halted. But as long as that will not be the case, and I said already that there is little reason for optimism, we - the members of the accountancy profession - have to continue our fight for the general acceptance and application of a proper system of accounting for changes in prices; specific changes as well as general changes; generating information of a high quality!

I am now at the end of my Conference Report, in which I have done my best to give you a picture of the trends and prospects of the subject under review. On an earlier occasion, when I delivered a report at a conference, one of my audience later remarked to me „Well, I am still confused, but . . . on a much higher level". Hopefully, a similar reaction will be the least of my accomplishments today!

Thank you very much.