I. Introduction
1. We could summarize Dudley Stewart’s comprehensive international paper as follows: Lack of valuation-standards makes it difficult to ascertain periodic financial results; lack of prospective information hampers the proper use of reported results.
2. Value, especially of capital goods, in a going concern, is connected with future use and future benefits. There is uncertainty in estimating those future benefits in an environment of rapid technical, consumitional, economic and social change. Uncertainty being a characteristic of value, and valuation being an important activity in calculating periodic results, there is a remarkable contradiction between “ascertainment” (acquisition of certainty) and the process of determining periodic financial results.
3. By putting a value on a capital good, we already give prospective information about its capacity to produce future values. By putting a value on a complex of assets, we give some indication about their ability to produce future yields. By recognizing the element of uncertainty, we must refrain from suggesting too much certainty in the uncertainty.
4. Reporting of financial results and of equity is improved when some major future trends are indicated. However, the indication of trends should only provide the elements for analysis and estimates and should not suggest certainty, where uncertainty predominates. Further, there is not one future trend but there are “broad range-bands of likelihood”. It could be suggested that indication of future trends should be expressed in such bands, rather than in one figure. Uncertainty itself has a trend of increasing uncertainty as the time-span widens and there comes a point where it is almost meaningless to extrapolate an average, even if it is surrounded by a band.
5. In the 1970 Dutch Act the function of the annual accounts of enterprises is stated as follows:
   The annual accounts provide such information that a sound judgment can be formed on the financial position and result of the enterprise and, to the extent to which annual accounts permit, on its solvency and liquidity.
   The balance sheet, together with the explanatory notes, reflects fairly and systematically the size and composition of the enterprise’s capital (i.e. breakdown of assets and liabilities) at the end of the financial year. The profit and loss account, together with the explanatory notes, reflects fairly and systematically the size and composition of the enterprise’s result for the financial year.
   These sections refer to the past but do not exclude reference to the prospective future figures.

II. Valuation concepts
6. The Act requires that:

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a. The bases underlying the valuation of assets and liabilities, and the determination of the result, comply with standards that are regarded as being acceptable in economic and social life.

b. The explanatory notes give an exposition of these bases.

c. If an alteration of the basis is of essential significance, such alteration be explicitly stated, showing its effects on the net equity and the results.

The legislation accepts the existence of more than one concept. The wording is purposely general in order not to restrict further development of concepts.

7 In the Explanatory Memorandum to the Act, the Minister expresses his expectation that organized business life together with the organization of accountants will be able to draw up an inventory of the concepts of valuation as they now exist and to test these concepts for acceptability within the framework of the functions set out in Para. 5.

8 In January 1970, Drs. A. M. de Bruin published the results of an analysis of the annual accounts of 259 Dutch limited companies. The analysis concentrated on the valuation methods used for fixed assets. Valuation and depreciation were based on:

a. historical cost  51%

b. historical cost, with additional depreciation  18%

c. historical cost, with additional depreciation (amongst which: a supplementary depreciation based on current value) being credited to a separate surplus account in the balance sheet  16%

d. current value  15%

9 The analysis clearly shows that the application of current value is more common in companies with large investments in fixed assets.

10 That the current value concept has not penetrated deeper in our country (where it has been taught and discussed for half a century) may partially be due to the fact that tax authorities do not accept it as a basis for depreciation. However, in The Netherlands, a company may deviate for tax purposes from the annual accounts publicly reported.

11 The current value concept is more difficult in its practical application than historical cost accounting. In the valuation process, such factors as environmental changes, higher costs caused by the use of obsolete equipment and price changes, have to be taken into account.

12 The picture of valuation concepts in The Netherlands confirms Stewart's observation, in this respect, that there is no uniformity and that it would be too restrictive to strive for it.

III. Return of Investment (ROI) Analysis

13 In his paper Stewart focusses out attention on the importance of the ROI co-efficient and points out (I.P. 82) that there are at least two ROI co-efficients, one giving the return on equity plus long-term liabilities, the other furnishing the return on equity only. The co-efficient is mainly used for selecting investment-opportunities. It is also a means of rating management-performance. Several factors influencing ROI figures should be taken into account.
14 The impact of the ratio equity/(long-term) debt on ROI. For comparable types of enterprise one could say that the more debt there is in proportion the equity, the higher the risk and the higher ROI should be. How do we evaluate that risk factor? Prospective information supplemented by uncertainty data could provide a means to measure risk. This type of information is not available to the outsider and company research on this subject and development of models have hardly started.

15 The impact of taxation on ROI. One could argue that it is management's task to obtain the optimum and that the investor is only interested in ROI after tax. In some types of analysis it may be valuable to neutralize the effect of taxation in order to obtain a true picture of the performance of the company. In that type of calculation interest + tax + net profit should be the numerator. In this respect it is interesting to mention that the Act requires specific information on interest paid, interest earned and provisions for tax on profits. In The Netherlands, profits are subject to company tax whereas interest charges are deductible. A relatively high proportion of debt thus increases the return on equity but increases the risk.

16 The impact of inflation on ROI. The investor compares the different investment opportunities, amongst others, investment in bonds and investment in shares. The interest rate contains an element of compensation for inflation. When comparing this "inflation-included" interest rate with returns (retained plus distributed earnings) on shares, should not the investor have insight into the provisions made by the company for inflation? Companies showing extra depreciation (above historical costs) as a specific item would meet this requirement.

17 The impact of depreciation policy on ROI. Not only the value concept on which depreciation is based but also the length of the depreciation period is significant. Some companies prefer a conservative period while others are able to apply a close-to-reality period. The ROI's of companies in the same line of business may thus show considerable differences. To eliminate this factor, one could use the cash flow (before deduction of interest and taxes on profits) as the best yardstick.

18 The impact of valuation on ROI. The volume of equity influences greatly the ROI co-efficient and depends strongly on valuation-practices. Where does a valuation cease to be conservative but still be acceptable and where does too low a valuation start to result in a hidden reserve? The Act makes it more difficult to conceal reserves by requiring that reserves and changes in reserves, if material, should be specified and explained separately.

19 The impact of lease on ROI. Leases (if not capitalized) as compared to ownership, diminish the numerator as well as the denominator of the fraction which defines ROI. In fact non-capitalized leases tend to withdraw part of the capital working in the company from the overall profitability accounting. Where the economic risk is with the lessor and the lease period is substantially shorter than the economic life of the leased object, one could not object. The more the economic risk is with the lessee, the more reason there seems to include lease in that type of ROI calculation which refers to the return on the aggregate of borrowed money and equity.
The ROI figure can be highly valuable over a period of time to a company with consistent accounting practices. For management, a projected ROI figure sets a target which it can try to accomplish by operating in the capital markets within the range of capital mixes which are acceptable to the company, as well as by translating the overall ROI into specific ROI’s given as targets to sectors of the business. This requires careful capital allocation to those sectors as well as proper pricing of the products or services of those sectors. In case the latter formula cannot be applied completely, one could use the formula-contribution to profit plus overhead as related to capital employed.

IV. The impact of inflation on profit and loss accounting

21 The traditional nominalistic formula (still applied by the Dutch treasury) simply compares equity at the end of a period with equity at the beginning. The balance (with adjustments for amounts paid in and paid out) is called profit. In the present era of inflation this formula is no longer valid. An index figure, reflecting the inflation during the period, should first be applied to the equity at the beginning, before deducting it from the equity at the end of the period. This method has been discussed by Drs. F. Graafstal in his paper “Harmonization of accounting principles and the concept of profits” for the Ninth International Congress of Accountants, Paris, 1967.

22 In traditional profit accounting, inflation is not completely ignored. Provisions to preserve the equity are made by feeding either open or hidden reserves and by retaining portions of the “earnings”. Accounting for real profit in periods of inflation could be performed by ascertainment of total surplus with the setting aside of the portion required to preserve the equity. The remainder can then be defined as (distributable) profit. Shareholders decide the portion of this profit to be distributed and the portion to be retained.

23 The total surplus over a period is built up by earnings on completed transactions and by differences in valuation. In an inflationary period, the revaluation of assets ensures that depreciation, and consequently cost accounting, is based on current values and that revaluation reserves are fed, thus contributing to the surplus. This (revaluation) surplus is not only, and not even primarily, available for preserving the equity nor, if there is any balance, for addition to profits. Two other parties claim portions of the surplus caused by inflation - the lenders and the treasury.

24 Lenders hedge against inflation by increased interest rates and by index clauses. That the loss, caused by a debt-increase, should be recovered out of the revaluation reserve seems reasonable. It simply means a split of this surplus, one part going to the lenders and another part going to the owners. It seems equally justified to draw on the revaluation reserve for a provision against inflationary interest charges in the future. It should not make any difference whether the cost of borrowed money is burdened by one technique or by another. Moreover, one should realize that, if depreciation is charged to cost on the basis of current value and if, additionally, interest
were to be charged at high inflationary rates, then the burden of inflation would be partially double-charged to the cost of the product. By charging the inflation portion of the interest against the provision, just mentioned, this double charging to cost could be avoided. The inflation portion of the interest rate is merely the expression of the manner in which the lender cashes his share in the revaluation of the assets.

25 Because of accounting complications, one might be inclined to continue to charge depreciation on the basis of historical cost and to charge interest on the basis of effective rate rather than on an artificially cut rate - but then, a part of the effect of inflation (accruing to the equity owners) is not reflected in costs. Moreover, the balance sheet would then contain hidden reserves and would not “reflect fairly and systematically the size and composition of the enterprise’s capital” (Para. 5).

26 As depreciation is only accepted on the basis of historical cost, the treasury taxes that portion of future depreciation which is in excess of historical cost. The revaluation-surplus is thus not completely free, the treasury holds a claim on it which should be reflected in a provision.

27 Revaluation of manu of the fixed assets may not reflect the inflationary trend entirely, due to the influence of environmental circumstances (Para. 11). On the other hand, revaluation reserves are drained by lenders (Para. 24, 25) and by the treasury (Para. 26). Because of these factors, the assets of many companies may not prove to be as good a hedge against inflation as shareholders might expect. Then the missing amount, required to maintain the equity on the level of current purchasing power, should for a greater part be drawn from the surplus generated by completed transactions, before real profit over the period can be determined. In such circumstances the semi net profit margin of the company should allow for this maintenance of equity provision. Since such a provision would most likely be subject to taxation, the margin should also allow for this burden.

28 Lenders protect against inflation by increasing their interest rates. Taxation in many cases takes away part of this built-in compensation, which tends to increase the compensation, which tends to increase inflation.

Lessors protect by indexing their rents. Where the interest rate underlying the calculation of the rent also contains an inflation element, the lessor is to a certain extent covered twice.

Entrepreneurs seek protection from inflation by charging to cost materials and depreciation based on current values and by making provisions for inflation-proof equity in their margins. Taxation frequently takes away part of those built-in securities, which tends to increase them. On the other hand, fully including the inflation factor beneath the risk factor in the margin and simultaneously applying current values to cost bears an element of double counting.

Both unsound taxation concepts as well as exaggerated coverage tend to increase inflation.

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V. Management audit

29 There is no doubt that competent experts can make investigations into all of the 16 subjects and more indicated in I.P. 82(b). Some of these subjects can well be within the scope of the auditor's expertise. As an adviser to management he can supply valuable services in those areas. However, we must consider whether on these 16 points an evaluating audit can regularly be made and, if so, whether the auditor is qualified and in the proper position to make such an audit and report on it.

30 Since objective yardsticks to measure and evaluate management performances on these subjects are hardly available, the evaluating judgment will always contain a good deal of subjectivity. Moreover, if this judgment is to be more than a mere comparison between standards and performances, it should also contain elements of analysis and advice for future consideration.

31 Such a management audit report would be presented to the principals of management and parts of it would become public information. This then would involve the auditor in both internal and external skirmishes and conflicts. Even if the auditor could free himself from his judgments, as expressed in his management audit report, management would no longer look upon the auditor as an independent person.

32 Furthermore, a management audit would certainly not be a oneman job. It requires expertise in very divergent areas such as marketing, industrial engineering, personnel management, etc. Should the auditor's firm either employ or be associated with such experts and would not in either case the auditor's responsibility for the report be incompatible with professional rules? Present professional legislation in The Netherlands would not allow a c.p.a. to associate with non-c.p.a. qualified partners. Furthermore, it is inconsistent with current professional rules for a c.p.a.'s certificate or report to cover those activities of employees for which the auditor is neither able nor qualified to supervise.

33 Not incorporating the management audit into his services does not mean that the auditor could not co-operate with such an audit. The management audit would require more, and more detailed, information than is usually given in an annual report. If a management audit really is going to be a periodic evaluation of management, there may well be a need for independent audit and certification of that type of information. Moreover the information system would have to be adapted to those needs and the auditor, in his advisory capacity, could play an important role. The auditor should not only be willing to include in the management audit his opinion on those subjects for which he is qualified but should insist on being heard. Without taking the responsibility for the report he could also be called upon to criticize the draft report so that such a report could become more valuable in respect of the factual presentation.

VI. The prospective element in reporting

34 The prospective element in reporting can be improved by:

- speedy yearly reporting of results and trends
• interim reporting
• sufficiently detailed reporting.

35 Automation of the accounting system, including the closing procedures, aids acceleration of the reporting. Auditing concepts and techniques should also comply with this development.

36 A greater degree of uncertainty must be accepted, particularly in regard to uncompleted transactions, the valuation of some assets and the proper determination of provisions. This is even more so in the case of the interim figures.

a. Interim reporting allows for a smaller time lag than yearly reporting, otherwise the information becomes obsolete.

b. Uncertainty, approximations and mistakes have a greater impact on the smaller monthly or quarterly amounts than on the yearly figures. This is so because the distortions are mainly a function of the size of the assets and liabilities.

c. The impact of season may decrease the significance of intermediate results.

d. Incidental and extraordinary profits and losses are given more attention during the closing procedures than for interim reporting. In most cases, management can work with approximate and even incomplete data. But, even for this internal reporting of results over short periods, checks should be developed and applied in order to detect and correct systematic errors in the approximation techniques.

37 In The Netherlands only the international companies, the banks and a few others as yet publish interim financial results. As of July 1971, new listings on the Amsterdam Stock Exchange of domestic funds will only be approved if the company is willing to issue half-yearly statements concerning its results. Companies already listed are advised to report their results half-yearly and these are not certified by the auditor. Although it is evident that an auditor does not take responsibility for unaudited figures, he has to watch that the interim figures are compiled and presented in a careful and consistent way according to the same principles on which the yearly reporting is based.

38 The Dutch Act does not require reporting of amounts of gross revenue. However, a more detailed breakdown is required with regard to costs:

- payroll (social charges included)
- depreciation on fixed assets
- depreciation on intangible assets
- profits or losses on participations (if not consolidated)
- profits or losses on investments
- earned interest
- interest charges
- extraordinary profits
- extraordinary losses
- taxes on profits.

Although these requirements are an improvement on those adopted previously, they still do not completely meet the criteria for prospective reporting.
39 Breakdown of gross revenue and costs, according to their selling and buying markets, would be a great improvement, especially if the trends in these markets are also available.

40 A prospective picture of a company can only be obtained by putting together various segments of information. The financial results are only one of those segments and, by definition, more retrospective if taken apart. The balance sheet contains an element of prospectiveness since it reflects values which bear a relationship to capacity for future yield. The reporting on trends in the markets is another of those segments and so may, in future, be the outcome of management audits. The accountant serves his function in maintaining and improving the presentation and in applying his best judgment on the valuations as presented by the management of the company. Beyond that he should not go. It is for each individual party to put all the segments of information together as to compile his own subjective image of the future. The accountant should refrain from certification of predictions. Only in those cases in which the prospective element in the yearly report would be grossly misleading should the accountant interfere.