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Recently the Canadian Institute of Chartered Accountants announced that it will shortly be issuing guidelines for the preparation of financial data restated to isolate the effects of general inflation. It is likely to make these guidelines mandatory during 1975, and perhaps later it will require that these adjusted amounts be disclosed in annual reports.

In this connection it may be interesting to look back at an International Congress of Accountants held in New York City in the middle of September 1929 to ponder the pressing problems of the day. At that Congress papers were given with titles that sound familiar today–for example, "Historical Versus Present-day Costs Including Post-war Revaluation and Exchange and Currency Problems." Another paper by a German author dealt with kinds of value: "purchasing-day cost value," "present-day cost value," "re-stocking value of the re-stocking day." Nowadays we have replaced those terms with others such as "past entry values" and "present entry values" and added others like "exit values" and so on. The paper referred to "apparent profits," stating that they are "made if in the income account and the cost accounting the costs are stated at a value lower than the value of selling day. Then the difference between the actual cost value and the value of today appears as a profit, although it would be needed for maintaining the substance of the assets." These apparent profits are now called phantom profits or inventory profits, and they are getting into the news these days. The SEC said this year that it would like to see them disclosed.

Another 1929 paper, also by a German, made the distinction between cost accounting adjusted "in conformity with the fluctuations of monetary values," i.e., a form of general-index adjustment, and values "established in conformity with present market prices," i.e., replacement values. This is an essential distinction, and at this point we will make a rough attempt to clarify it.

The kind of adjustment that applies a general price index to the accounts is designed to do only one thing: change the unit of measure from a dollar, the value of which changes over time, to a single unit of general purchasing power. Thus, all the restated amounts in a set of financial statements would represent units of *equal* purchasing power, but the statements would still be based on historical-cost principles. We can label this the "general price-level restatement method."

The other major variety of accounting used to cope with changing prices we can call "current-value accounting." Several varieties of this have been advocated, but for simplicity let us think of the Dutch system, which is designed to make charges to income through depreciation and cost of goods sold at a level based on current replacement costs. The theory is that the capital of the company has not been maintained if the determination of income ignores the changing cost of maintaining goods and plant at the same physical level. This method is a complete departure from the present historical-cost system, and its only relationship to the general-index method is that *both* of these methods of correcting for changing prices can be applied together.

A comment at the 1929 Congress did not miss this point: "Questions of exchange and currency problems will affect both views or methods in substantially the same way, for historical as well as present day values must ultimately be expressed in terms of a stable currency to have much significance."

It should be noted that in 1929, as today, not all accountants were in favor of any departure from conventional accounting:

> Surely those millions of the investing public would be plunged into the welter of utter confusion if it were attempted to adjust values from time to time to correspond with price levels. We should reflect very gravely before we depart from a system which gives the investor such clear and definite information regarding the affairs of a concern in which he is financially interested, ever remembering that it is by consistency in practice and the adherence to recognized principles that the confidence has been gained which has led the public to take so large a part in the financing and consequent development of industry in all its branches.

And another:

> Until we can develop some financially sound basis of giving effect to these constantly changing economic factors does it not behoove us as accountants to adhere to the principles which in the past have proved successful? To paraphrase the words of the immortal Shakespeare— "It is better that we bear those ills we have / Than fly to others we know not of."

Other major changes in the accounting system have been proposed as giving a better approximation of economic profit—the increase in "welloffness" of the enterprise or its owners. These are mostly based on balance sheets with assets at selling values or discounted future cash flows. As a practical accountant, the writer has to say that this sort of accounting is presently science fiction–interesting, but it won't get you to the moon. In any case, these proposals really have nothing to do with accounting for inflation.

Accounting on the basis of current costs was not a new thought, even in 1929. A commentator pointed out that "Ricardo after the great war against Napoleon the First recommended present day cost accounting" and that "Carey recommended it after the Civil War in America." Thus, it is a little painful to hear some firms of chartered accountants in Canada busily thumping the drum at the rear of the line, trying to suggest that they are leading the rest of our profession in the matter of accounting for inflation. Their public-relations efforts would have been somewhat more impressive if they had occurred before the subject was well advanced on the official agendas in the United States, the United Kingdom and Canada. Their behavior might be described as that of three wise men arriving at Bethlehem, not bearing gifts but rather proclaiming the need for a messiah. Mind you, they are rather more than nine months too late.

The following paragraphs sketch some of the accounting efforts that have tried to cope with inflation internationally. Many of these are tied up with questions of taxation, partly because in some countries the published accounts are wedded to the tax basis and partly because management has often been loath to reduce profits without a countervailing reduction of taxes.

LATIN AMERICA

In Argentina in the 1960s business enterprises were permitted to revalue fixed assets for tax and for accounting purposes. In 1972 annual revaluation of fixed assets using the wholesale price index was made compulsory for large companies and permissible for all. This revaluation had the effect of indexing depreciation charges, thus reducing taxes and also reducing profits available for dividends.

In Chile annual revaluations of fixed assets based on the consumer price index have been required since 1964. Depreciation in the accounts and for tax is based on the higher values. In addition, an amount calculated by reference to the inflationary loss of shareholders' equity can be deducted in an amount of up to 20 percent of taxable income. Both this amount and the increased depreciation also reduce the profits available as dividends. In addition to these recurrent adjustments, occasional inventory revaluations have been permitted, which have the effect of imposing a lower rate of income tax on the inflationary gains.

In Uruguay enterprises must revalue their fixed assets every two years for tax purposes, using official indices which provide a minimum and maximum adjustment. The increased depreciation reduces income taxes. If the revaluation has been recorded in the accounts, it also reduces profits. Surprisingly enough, revaluation is the usual practice, and auditors have been known to give qualified opinions where the revaluation and higher depreciation were not recorded in the financial statements. Occasionally, inventories in Uruguay are written up in the accounts, providing a tax deferral until such time as the resulting reserve is paid out as dividends.

In Brazil in the 1950s restatements of fixed assets based on changes in the general level of prices were permitted, but depreciation allowances for income-tax purposes were not changed thereby. The purpose of the restatement was to increase the recorded net worth and thus reduce excess-profits taxes. Since the writeup itself attracted a 10-percent income tax this was a mixed blessing, and not all companies made the move. In 1965 such restatements of fixed assets were made mandatory. This time there was a resulting increase in depreciation allowed for tax purposes. Even then as now, the tax man giveth and the tax man taketh away—the writeup attracted a 5-percent income tax, which was later reduced for some companies and finally abolished in 1967. As a result of these tax moves, the restatement of fixed assets and depreciation charges on the basis of an official index is considered to be the generally accepted accounting basis in Brazil. The erosion of purchasing power of working capital may also be measured, using official indices and giving tax relief, but a countervailing requirement to purchase and hold government bonds for two years has made this option unpopular.

FRANCE

From 1947 to 1958 France permitted fixed assets to be revalued on the basis of certain wholesale price indices. In 1959 companies were permitted to make one final adjustment, and the larger companies were required to make the minimum adjustment. Unlike the earlier revaluation, this one was subject to a special tax at a low rate, but it provided later benefits. All of these revaluation writeups could be distributed as dividends, but cash dividends were restrained by certain other tests. Since 1959 revaluation of fixed assets for tax purposes has not been permitted and is now rare in published accounts.

Inventories have not been permitted to be carried above cost, but for some years up to 1958 a formula based on price changes and inventory levels isolated some of the profits from taxation. In 1959 and later a tax formula permitted tax deferrals related to reserves for increased costs of inventories, and typically these reserves appear in the annual reports as well.

ITALY

In Italy between 1946 and 1952 legislation permitted tangible assets to be revalued using prescribed indices. Although the resulting amounts were available for dividends, they could also be subject to taxation, so the revaluation tended to be made only where the tax could be avoided.

THE NETHERLANDS

In the Netherlands we find an interesting situation. Almost half of the companies quoted on the Amsterdam Stock Exchange are wedded to historical-cost accounting. The remainder provide in some way for depreciation based on replacement values. The rejection of the historical-cost system is even stronger among professional accountants. Perhaps this explains the prevalence in practice of the replacement-value method, even though no tax advantages are obtained.

The same underlying theories can be applied to inventories and cost of goods sold. Philips, for example, does do this. Their annual report presents a restatement for the benefit of those of us locked into the historical-cost approach.

GERMANY

Germany is an interesting case. Much of the earliest writing on replacement-value accounting came from German authors. Nevertheless, with the exception of one time in June 1948, valuation of assets above cost has not been legal, and, in spite of three bouts of strong inflation, German accountants have not been able to move from the historical-cost basis.

However, some relief under the tax laws has been obtained. For example, if prices of inventories have increased by more than 10 percent in a year, those stocks can be written down. Alternatively, certain imported raw materials can be written down by 20 or 30 percent. For fixed assets, gains from the sale of capital items can be applied against replacements made on a timely basis if certain provisions are met. Although all of these are technically deferments only, they tend to be relatively permanent. These writedowns became an integral part of financial accounting and are permitted under the company law.

The theories of replacement-value accounting are also retained in a way that seems very indirect to us over here. However, it appears that these arguments caused a significant change in German company law. Until the late 1950s the entire reported profit of a publicly owned company was subject to distribution whether the directors liked it or not. The accounting profession recommended that the tax law, and presumably the company law, permit the establishment of replacement reserves related to fixed assets. This was rejected, but the company law was changed in 1965 to provide for retention of half the profits until this reserve comes to 50 percent of the capital stock of the company.

Considering the ratio of retained earnings to capital stock over here, it can be seen why German accountants are concerned for the continuity of the enterprise. No wonder they are striving to develop a method of replacement-value accounting that will become accepted for statutory reporting and for tax purposes.

In the meantime, supplementary information is being provided by a few companies. The 1972 report of Portland-Zementwerke Heidelberg states:

> Since 1970 the company has concentrated on the problem of eliminating the fictitious profit that has not been earned due to inflation. The annual report to stockholders in 1971 for the first time mentioned in detail how the price increases had affected the equity of the company. Detailed calculations were presented for the first time in 1972. The calculation resulted in the reserve for replacement amounting to DM 12 million (as compared to DM 11 million for 1971). However, under the law the company could reserve as earned surplus according to section 58, ss. 2 of the law only DM 10 million.

Others making similar disclosures are Eternit AG, Haake-Beck Brauerei AG, Siemens AG and Mannesmann AG.

How about general price-level restatement in Germany? A long time ago Professors Mahlberg and Schmalenbach proposed a method that could be described as a primitive version of the U.K.-U.S. general-index method. However, it seems not to have much support these days in Germany among the working accountants.

EUROPEAN ECONOMIC COMMUNITY

Early in 1974 the Commission of the European Economic Community (EEC) dealt with current values in Article 30 of its Amended Proposal for a Fourth Council Directive, permitting member states to authorize replacement-value accounting for fixed assets and inventory. They also provide for other methods which take into account current values in accounting for those assets as well as investments and other financial assets. It would be a mistake to think that this is intended solely to accommodate Dutch companies that follow these methods. The International Accounting Standards Committee (IASC) includes other supporters of specific accounting reaction to changing prices, and, as noted for Germany, this is not a recent development.

THE UNITED STATES

Accountants in the United States have not ignored the problem of inflation. They tend to support the general price-level restatement approach.

In 1963 Haskins & Sells gave a clear opinion on price-level restated accounts of Champion Celulose SA of Brazil. This was a clean opinion. About the same time Arthur Andersen & Co. assisted a subsidiary of General Dynamics in Brazil in presenting a comparative series of price-level and historic-unit accounts. They said the restated accounts were not in accordance with generally accepted accounting principles, but that they should be.

For several years the reports of Indiana Telephone Corporation have presented both historical and adjusted accounts. AA's opinion says that the adjusted accounts present the financial position and results *more* fairly, since recognition has been given to changes in the purchasing power of the dollar.

The same annual report contains other inflation-index-adjusted data. The writer was less than amused to note that they showed the Dow Jones average on a *deflated* basis as reaching a high of about 350 in 1965 instead of the reported 900 plus. The same average showed under 250 in 1971 when the unadjusted Dow was almost 900. It would be depressing to see what the same restatement would show today. Maybe the Dow has really found its way by now below 1929's wonderful mark of less than 50.

The trend in the United States seems to be toward disclosure of supplementary information based on general price-level adjustments. This goes back at least to the 1930s in terms of academic proposals. In 1951 the American Accounting Association, still primarily academics, suggested that the effect of price changes should be measured using a general price index, but by 1957 the same association felt relevant information could best be developed using replacement costs or specific price indices.

Nevertheless, in 1963, when the American Institute of Certified Public Accountants published a research study on the subject, the recommendation was for restated information based on the U.S. Gross National Product Implicit Price Deflator, thus plumping for general price-level restatement and not for something based on replacement values. This same approach surfaced in 1969 when the Accounting Principles Board issued a Statement suggesting that supplementary information be given based on the general-index approach, but specifying that such information was *not* necessary for fair presentation. This statement produced very little response in published reports. In fact it is only just now that there seems to be a likelihood that companies will produce this information.

Meanwhile, the matter is still under study by the Financial Accounting Standards Board. The Board has issued a discussion memorandum and has held public hearings on the subject. The next expected step would be an exposure draft.

The latest word is that, through the Financial Executives Institute, a large number of companies have agreed to test the usefulness of price-level-adjusted financial statements. It also appears that the FASB will coordinate the price-level project with the one on translation of foreign currencies. This last seems a good idea. Aside from the need to integrate the two translations—one from a foreign currency to a domestic one, the other from the domestic currency to a unit of uniform purchasing power—it is essential that one part of the problem not be prejudged by pronouncements on the other.

The major message from the FASB seems to be that it will be some time until they expose any draft statement on price-level-adjusted accounting.[1]

THE UNITED KINGDOM

Meanwhile, the United Kingdom has moved into the lead. In 1971 a discussion paper was issued on general price-level restatement. In February 1973 a draft statement of standard accounting practices was issued, and in May 1974 a *provisional* statement of standard accounting practice appeared.

What does "provisional" mean? It can be viewed simply as a courtesy to the U.K. government, which had belatedly gotten interested in the subject of

1. As it turned out, the FASB issued a draft statement earlier than the author expected, but the unusually long exposure period provided by the Board appears to be an alternative manifestation of the caution needed in approaching this complex subject (February 1975).

accounting in the face of inflation, had appointed a committee to look into the matter and asked accountants to wait just a year or so. Rather than wait, the standard has been issued, not as binding on the profession but as persuasive. This persuasion, however, is typically strong. The statement itself says, "It is believed that the procedures outlined in this statement will receive substantial support from major companies." It is unlikely that that will be left to chance. The support of the Stock Exchange, the Board of Trade, the City and all that goes with it may be expected to result in most if not all U.K. listed companies following the standard.

INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

Within a year from its formation in June 1973, the Committee realized that it could not leave the problem of changing money values to forty or fifty national organizations. It therefore created a study group to work on both responses—general price-level restatement and current-value accounting. While it is not clear where the IASC is headed or when it will arrive, it *is* clear that presently there is less uniformity in practice internationally than is desirable. Aside from the many and varied piecemeal adjustments made occasionally or often in some countries, there are at least two conflicting overall systems being used to cope with changing values: It looks as though the United Kingdom, the United States, Canada and some Latin American countries are headed for supplementary disclosure, based on general price-level restatement, while Holland and other European countries are likely to lean toward replacement-value accounting.

In the writer's opinion, both groups are half right, and perhaps it is not being overly optimistic to suggest that we are all taking first steps toward accounting relevant to an international community and to international problems. •