CONTINUOUSLY CONTEMPORARY ACCOUNTING

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Continuously contemporary accounting was devised to do what other alternative systems proved unable to do. It attacks the same problems but it attacks them systematically. And it attacks problems which other proposals have passed over and still pass over. Over the fifteen years in which it was developing, I believed successively (a) that historical cost accounting had to be endured; (b) that indexed adjustments for inventories and depreciation would suffice to cope with the effects of inflation; and (c) that replacement price accounting would be the best alternative. Each of these was rejected when it was found that it failed to resolve one or more of the problems presently to be specified.

The rules of C.C.A. are few and simple.

A. All accounting for transactions is done as at present.

B. All assets in possession at the end of a year are valued at their money equivalents; for non-monetary items this means their resale prices. All differences between book values and the money equivalents of year-end assets are described as price variation adjustments. They are credited or debited, as the case may be, to the appropriate asset accounts and debited or credited to the income account.

C. There is calculated a capital maintenance adjustment equal to the opening amount of net assets (total assets less total liabilities) multiplied by the proportionate change in the index of the general level of prices during the year. This is debited to the income account and credited to a capital maintenance reserve (which is part of the owners' equity accounts).

D. The net profit of a year is the algebraic sum of transaction surpluses (selling prices less book values), price variation adjustments and the capital maintenance adjustment.

E. The balance sheet will represent assets uniformly at their money equivalents; the amount of assets, and the equities of creditors and shareholders in the aggregate amount of assets, will be expressed, as a result of the above rules in units of currency of equal and up to date financial significance.

The setting of the argument is as follows. The typical business firm, by force of circumstances or of its own initiative, makes financially significant choices from time to time. A financially significant choice is one which entails non-trivial outflows and inflows of money. Having no confiscatory or coercive powers, the consequences of the firm's choices must be tolerably satisfactory in certain key respects to its managers, creditors and shareholders. Whether the position and results consequential upon past choices, actions and events have been satisfactory, can only be judged if dated positions and results are properly discovered and reported, in terms intelligible to the several parties. Dated positions and results are also serviceable as a basis for forming some (but limited) expectations of prospects.

Problem 1 - Correspondence: to obtain financial statements which correspond with actual positions at stated dates, and results for stated intervals.

No satisfactory judgment or choice can be based on statements of position and results which contain fictions, or which are not matters of financial experience. Financial experience relate to sums of money received or paid or held and prices expressed in money; they include changes in prices and changes in the general level of prices (or changes in the general purchasing power of money). Examples of fictions are "lower of cost and market" valuations of inventories, and price-level adjusted original costs; there are many other examples of such fictions.

Problem 2 - Dated Positions: To obtain dated statements of position which correspond with the actual financial position.

Merely to perform bookkeeping operations or calculations on original entries will not secure that periodical statements correspond with actual particulars. Only if the cash balances, the amounts of money owed and owing and the quantities and prices of non-monetary assets are actually ascertained at balance date, and incorporated in the accounts, will dated statements correspond with real positions. The dated prices of non-monetary assets will embody the effects of changes in the specific prices of the assets of a firm (see Rule B above).

Problem 3 - Periodical Results: To obtain a net result or outcome which corresponds with the increment in net assets.

A net result (or net profit or net income) which is simply the residue after applying any chosen set of bookkeeping rules has no necessary financial significance. A net profit is financially significant only if its amount corresponds with an increment in net assets (exclusive of new contributions by owners and of dividend payments). Such an increment may be determined, by subtraction, from two successive statements of financial position, or by making appropriate periodical adjustments to figures derived by the usual bookkeeping processes.

Problem 4 - Aggregation: To obtain statements of position and results which do not violate the rules of addition and subtraction.

A balance sheet is an aggregative statement; financial position is an aggregative notion; net income is a difference. The operations of addition and subtraction can only be applied legitimately to magnitudes which represent the same financial characteristic of the items for which an aggregate magnitude is to be found. A series of current purchase prices can properly be added, It would represent a "buying list" or potential commitment to purchase. It would not represent capacity to buy or capacity to pay debts. It therefore could not legitimately be added to an amount of cash in hand, which does represent capacity to buy or pay debts. For the same reason it is improper to
Problem 5 - Relation: To obtain statements of financial position and results, the components of which can be validly related in any financially significant manner.

Among the financial features of firms which are of practical importance are the current ratio, the debt to equity ratio and the rate of return. These three embrace (in different combinations) all the elements in a set of financial statements. They are relations between aggregates. They are valid indicators only if they represent relations between genuine dated money amounts. The valuation of assets at money equivalents satisfies this condition.

Problem 6 - Inflation: To take account of the change in the general significance (general purchasing power) of money during each period.

Under inflation, specific price changes and the general purchasing power of money changes. Changes in the money equivalents of specific assets have already been dealt with in relation to financial position (problem 2). And income has been described as the increment in the amount of net assets (problem 3). Since liabilities constitute a hedge against loss in general purchasing power, only the amount of net assets at the beginning of a period is at risk of loss in general purchasing power. But the purchasing power equivalents (or general purchasing power) of the dollars at opening and closing dates of a period are not the same. Under the aggregation rule, they must be made the same if a proper difference between opening and closing amounts of net assets is to be computed. Multiply the opening amount of net assets by the proportionate change in an index of changes in the general level of prices. Call the product a capital maintenance adjustment (see Rule C above). Charge its amount against the sum of transaction surpluses (selling prices less book values of goods sold) and net price variation adjustment (differences between pre-closing book values and retained money equivalents of assets). The residual will be net profit (in dollars of closing general purchasing power, the same as all other items in the balance sheet) after allowing for the maintenance of the general purchasing power of the opening amount of net assets (see Rule D above).

Problem 7 - General Relevance: To obtain statements, the contents of which are relevant to the consideration of any future course of action.

On the discovery of its results and position, a firm may wish or be obliged to change its operations or assets and liabilities. It may wish to consider a variety of re-deployments of assets and variations in liabilities. The money equivalents of assets must be known for these purposes, equally for every future course of action considered. Asset valuations based on particular assumptions about future operations or investments, as in replacement price accounting and present (discounted) value calculations, would not be serviceable; for they are specific to a singular set of future operations and no other.

Problem 8 - Risk Indication: To obtain financial statements which show the full effects of all factors on positions and results, the variability of net income and the money amounts at risk of specific changes in asset prices.

If assets are shown at money equivalents, the amounts at risk of specific changes in prices are disclosed. As the system takes account of all factors in a comprehensive way, fluctuations in wealth and income are disclosed; there are no alternative valuation or calculation rules by which this may be avoided or by which income may be "smoothed". Current ratios and debt to equity ratios, being based on money equivalents, will indicate fairly the risks of creditors.

Problem 9 - Comparability: To obtain financial ratios which may be compared over successive periods for a given firm or as between firms at a given date or over successive periods.

Under inflation, absolute magnitudes cannot be compared over successive periods, since they will be expressed in dollars of different financial significance. But properly derived ratios (problem 5) can be compared. Because C.C.A. entails the use of one common valuation rule and an inclusive mode of calculating net income, the ratios of different firms may be compared for a given period or a succession of periods.


All systems purport to deal with Problems 2 and 3. But C.P.P. and C.V.A. do not deal fully with Problems 1 and 4. As for Correspondence, both resort to fictions. A price-level adjusted cost (under C.P.P.) is not a matter of experience; and a replacement price (under C.V.A.) has no bearing on position or results at a date prior to replacement. As for Aggregation, both C.P.P. and C.V.A. entail the addition of different kinds of magnitude; they are logically invalid. Both must therefore fall short as solutions to Problems 2 and 3. For the same reason they fail as solutions to Problem 5. C.C.A. fails none of these tests.

Because they deal only partially with changes in prices and changes in the purchasing power of money, C.P.P. and C.V.A. fail as solutions to Problem 6. And because the other problems stated are corollaries of the first six, C.P.P. and C.V.A. fail in respect of them also. For the same reason C.C.A. succeeds as a solution to the remaining problems.

C.P.P. and C.V.A. fail principally because they are constructed on the premises (a) that book figures may diverge from hard facts of financial experience, and (b) that the basic rules of arithmetical operations do not apply to accounting. C.C.A. succeeds because it is not based on these and other unrealistic premises.

Summary. The "problems" for which C.C.A. provides a solution are all pertinent to users of accounts - managers, investors, creditors, analysts, wages and price tribunals, and others. The C.P.P. and C.V.A. exposure drafts and the other expositions of those systems (including the Sandlands Committee Report) completely disregard some of them and deal only superficially with others.

The main characteristics of C.C.A. are as follows:

1. C.C.A. records and reports the financial effects of transactions and events as they occur. It uses no confusing fictions. In particular, it has no other "unit" than the "dated dollar", which always represents both an amount of money and
To minimize manipulation of profits I reject the idea of including inventory at selling price and thereby bringing to account unrealized profits.

I likewise reject the need to use replacement prices for similar reasons to my argument on depreciable assets. I believe if one goes back to the basic principles which one would develop in a period of net nil inflation if prices are rising in your industry you would regard replacement price as a future cost and conversely if your prices are falling you would regard the difference as a future cost saving and you would bring neither to account. In a period in which there is general inflation I would apply the same argument regarding bringing to account future costs or future cost savings.

CPP SUMMARY

In summary a CPP Balance sheet and profit and loss account will tell us:

1. Whether or not shareholders funds have been kept intact bearing in mind the method of valuing assets on the "continuing business" basis outlined above.

2. The monetary assets and liabilities in precise terms.

3. The depreciable assets at figures which we know are not related to market or replacement prices but are a combination of unexpired costs (which we expect to be able to feed into production costs in the future) and residual scrap values (if desired market values for the scrap could be shown).

4. The profit or loss expressed in end of year dollars (I have not attempted in this paper to explain the method of achieving this).

5. The profits and losses of a series of years all expressed in the currency of one common year, normally the most recent year. This latter technique is comparable with the expression of the gross domestic product (GDP) in constant (say 1967) prices which gives a measure of the increase in volume of the GDP.

SOME CLOSING THOUGHTS

I believe any system which attempts to reflect the effects of inflation must deal with every item in the accounts or the results will be misleading. The current value method proposed in the Australian exposure draft, the Mathews report and the Sandilands report, require only inventory and fixed assets to be dealt with and in effect say that the preservation of operating capability in the industry in which the company finds itself is all that is necessary. It must be recognized that every company has a different balance between shareholders funds and outside borrowings. A company with large outside borrowings and minimal shareholders funds has minimized the exposure of shareholders funds to capital erosion. If only some of the effects of inflation are reflected companies will find themselves with a disincentive to seek outside borrowings as a hedge against inflation which is surely not the real world.

You will have observed that the accounting profession, the stock exchange and the legislators are all working towards strict rules of accounting to minimize variation from company to company and to minimize manipulation. I believe it is imperative that we find a system which is the subject of rules and can be verified reasonably accurately. This is a further attraction of the application of a general index to all companies in a consistent way rather than permitting a method involving estimation of market, replacement or selling prices.

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the "dated" general purchasing power of that amount.

2. C.C.A. takes systematic account of all changes, up or down, in the prices (money-equivalents) of the specific assets of each firm.

3. C.C.A. balance sheets represent assets at up-to-date money equivalents in dollars of up-to-date general purchasing power. No amount is shown for assets for which there is no money equivalent or resale price in the ordinary course of business. Liabilities are shown at their actual contractual amounts. These balance sheets are realistic statements of dated financial positions.

4. C.C.A. takes systematic account of gains or losses in general purchasing power, both in respect of net monetary items and in respect of the opening amount of the investment in other assets (i.e. through the capital maintenance adjustment).

5. C.C.A. income is calculated by reference to the maintenance of the general purchasing power of the opening amounts, in any year, of a firm's net assets and of the shareholders' equity (since, by definition net assets equals shareholders' equity).

6. C.C.A. income is a genuine increment in dated general purchasing power in a year.

7. C.C.A. yields a rate of return which is the same in kind as, and can be compared directly with, interest rates, bond rates and other rates of return.

8. C.C.A. accounts in series represent a complete financial history of a firm, since they are inclusive of the effects of trading transactions, asset price movements and changes in the general purchasing power of money.

Neither C.P.P. nor C.V.A. accounts has these characteristics. As they are all of practical importance, the superiority of C.C.A. is demonstrated.