MAINTENANCE OF OPERATING CAPACITY
in
AN INFLATIONARY ENVIRONMENT
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Investors need for realistic information concerning the operating results and state of affairs of the companies in which they have invested are inadequately served in times of inflation by historical cost based financial statements.

In conventional financial statements the changes in values of non-monetary assets held through a period of price increase are only recorded as and when the historical costs of such assets are expensed against revenues. Further, such inflationary elements are not isolated in the profit and loss account. Reported earnings therefore fail to disclose the results of current operations expressed in terms of current price levels and are distorted by the inclusion of inflationary profits that have arisen over an indeterminate period of time.

The result is a profit and loss account which is a mixture of operating and inflationary gains and losses, which contains an assortment of residual amounts of historical transactions entered in different years at different price levels.

Acknowledging these shortcomings, the accounting profession are currently devoting considerable time and effort to an analysis of the alternative methods that have been proposed to account for the effects of inflation.

At present rates of inflation an urgent need exists to adapt conventional reporting procedures and thereby provide information that serves better to permit soundly based investment decisions and to ensure an informed allocation of resources and wealth in the community.

Accompanying this need it must be acknowledged that there is the underlying requirement to analyse and explore the basic objectives of financial reporting which have never been codified. However, it is fair to say that it will take some time for such objectives to be formalised and agreed. In the meantime it would be unwise to attempt more drastic modifications to our accounting framework, such as the realisable value proposals which would seek to depart from the conventional cost and revenue matching procedures for profit determination and from the realisation concept of operating profit recognition.

Whilst limiting any change in financial reporting procedures to accounting for inflation, there is nonetheless a need to define the purpose and usefulness of the financial data thus produced. In this regard, it is a vital prerequisite that the system to be adopted will in some way serve to assist financial management in pursuing policies that will keep the real capital of business enterprises intact and not allow a concealed erosion of such real capital to occur by profit distributions that include and do not identify inflationary holding gains.

In other words the reporting process should be such that it will reveal whether or not businesses are maintaining the value of the physical resources that are the means to continued profitable operations. The inclusion of holding gains in income not only distorts the real level of current operating results but, by disclosure a distributable profit threatens to erode the productive capacity of the business. If distributed, the future income earning potential of the business would be impaired unless replaced with further capital injections. The need to replace profit so distributed with fresh capital just to maintain the status quo calls to question the established historical cost concept of profit.

A further objection to the inclusion of holding gains in income is that unless they can be identified the accounts of two or more companies cannot be compared in terms of gains that result from the skill or good luck of buying at the right time, as distinct from the results of conducting a manufacturing or commercial operation in current conditions at current cost levels.

From the balance sheet point of view, balance sheets have never in the past purported to represent statements of asset values. Whilst profit performance and dividend cover are normally the prime considerations to the investor, a meaningful representation of the worth to the business of the assets, including those committed to long run operations, is useful information to the investor and analyst. Information concerning market realisable values may also be useful in certain circumstances such as the impending cessation of operations, or where there is a substantial excess of realisable values over current replacement values.

Such information, however, could be adequately provided in footnotes whilst preserving in the balance sheet a consistent measure of asset values arrived at having regard to their economic value to the business.

In this regard the definition of value suggested by Professor Bonbright is appealing. Under Bonbright's definition, all assets would be consistently valued in terms of their worth to the owner determined by the dollar value representation of the loss that would be suffered if the company were deprived of their use. This loss would normally be represented by the cost of replacing assets in profitable use. In some circumstances the value to the owner of an asset will be less than current replacement cost and in such cases the value would be the greater of net realisable value and economic value to the business. This latter value would represent the estimated future cash flows to be generated by the use of the asset. (This is in fact the approach recently advocated by the United Kingdom Sandlans Committee).

It will come as no surprise from the foregoing discussion that the writer rejects the current purchasing power approach to inflation accounting and supports a current value approach based upon value to the owner.

It follows that limited support only is given to the current value accounting preliminary Exposure Draft issued by the joint Australian accounting bodies. The approach advocated by that Exposure Draft is a rigid replacement cost approach, not recognising distributable
profit until provision has been made to replace all so called “essential” assets consumed in earning revenue. This approach ignores the fact that the company may well decide not to replace such assets when in due course they become worn out and may in fact choose to switch to a completely different type of asset, thereby perhaps totally changing the nature of its business.

A further objection to the current value Exposure Draft lies in its decisions to leave aside the question of so called gains on net monetary liabilities. Clearly this is a question that requires resolution before any final statement can be issued. The alternatives of, on the one hand, ignoring and on the other, bringing to account in the profit and loss account such gains has massive implications in terms of the diverse extremes of reported earnings that would result.

Leaving aside the question of whether or not such gains exist separately from the holding gains on non-monetary assets they help finance (a question bound up with the concept of generalised purchasing power - and whether or not this, rather than the monetary unit should be adapted as the unit of account) it must be acknowledged that shareholders benefit at the expense of lenders in times of inflation - provided that the interest rate charged is not so high as to offset any such benefit.

Whilst it can be argued that such benefit is automatically reflected and disclosed as part of the total holding gains on non-monetary assets, it would be useful to assess and highlight this gain and contrast it with the interest charge thus showing the overall effect of financing operations as distinct from trading operations.

A procedure could easily be employed to ensure that such gains are not distributed, thus eroding the total asset base of the company necessary to maintain the continued level of operating capacity. Such a test would require demonstration that the company has maintained by additional borrowings the real (as opposed to historic) purchasing power of debt finance.

Summarising the foregoing, the writer would propose the following major modifications to the second Preliminary Exposure Draft:

(a) By incorporating the notion of generalised purchasing power, measure and record the monetary gain on borrowings in the profit and loss account as a separate item, together with the related interest expense;

(b) Instead of assessing the values of fixed assets and the related depreciation charge at either replacement or realisable value, depending on whether or not they are regarded as “essential” or “non-essential”, value and depreciate all assets by reference to value to the business. Such value to the business would be determined in accordance with the formula:

\[
\text{The lower of} \quad \frac{\text{replacement value}}{} \quad \text{and the greater of} \quad \frac{\text{realisable value}}{\text{economic value}}
\]

(c) Charge the depreciation backlog to asset revaluation reverse rather than retained earnings. Such adjustment is not necessary when it is acknowledged that the full loss of value to the business of fixed assets each year is charged against operating profits and the more rigid objective of funding the replacement of assets is rejected.

In making these observations it is acknowledged that much difficulty and debate arises because the issues are confined within an accounts format that requires a “profit and loss account” and calls for the determination of a “profit for the year”. The choice is therefore often hard as to what is profit and what is a capital adjustment, particularly as regards holding gains.

These difficulties would be avoided if a more radical change were made in the accounts format and if instead, as the key financial statement, a form of equity movement statement were adopted setting out all movements in shareholders equity for the year, grouped in appropriate components and accompanied by helpful interpretive date. A suggested format is set out below.

**FINANCIAL REPORT - YEAR 19X0**

<table>
<thead>
<tr>
<th>SHAREHOLDERS' EQUITY</th>
<th>NET BUSINESS ASSETS</th>
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</thead>
<tbody>
<tr>
<td>Opening balance $xxx</td>
<td>Opening balance $xxx</td>
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<tr>
<td>Adjustment for general inflation for year $xxx</td>
<td>Additions to net operating assets, at cost $xxx</td>
</tr>
<tr>
<td>Increase in capital $xxx</td>
<td>LESS:</td>
</tr>
<tr>
<td>Internally generated funds: Increase in borrowings $xxx</td>
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<tr>
<td>Operating profits $xxx</td>
<td></td>
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<tr>
<td>Extraordinary income $xxx</td>
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<tr>
<td>Relative purchasing power gains arising from: Adjustment arising on revaluations of non-monetary assets $xxx</td>
<td></td>
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<tr>
<td>Borrowings (interest expense $xxx) $xxx</td>
<td></td>
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<tr>
<td>Revaluations of non-monetary assets $xxx</td>
<td></td>
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<tr>
<td>Dividends paid (xxx) $xxx</td>
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<tr>
<td>Closing balance $xxx</td>
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Closing balance $xxx

It will be seen that the foregoing statement combines all important features of the components of the financial results for the year with a summary of both the real changes in net operating assets and those resulting from value adjustments. It is thus the key statement to which all other supporting analytical data can be related and cross-referenced. To keep accountants satisfied, it also balances!

Is such a radical change too much to ask for? The answer is no small way lies with major financial statement user groups and the extent to which their views are made known. It is hoped that this article may have assisted in some way the formulation of such views and that these will be communicated to the joint Australian accounting bodies with clarity and haste.