CHAPTER IV
In the U.K., inflation created a very acute working capital scarcity in the industry in the early seventies and the government announced a specific relief in income tax known as stock appreciation relief, to enable the companies to exclude for tax purpose, the higher values of the same quantities of the closing stock in the successive years.

A number of studies established that many companies had been taking unsound financial policy decisions because of their sole reliance on accounting statements based on historical costs. The growth rate in real terms was lower than shown and the profit increase in real terms was much less than what it was supposed to be earlier.

Faced with the above situation, accountants in the U.K. offered a solution in the form of the "current" purchasing power method" which seeks to adjust the financial statements by removing the effects of changes in the general purchasing power of money on traditional accounts. The method is being discussed later -

A committee under the chairmanship of F.E.P. Sandilands was set in the U.K. in January 1974, to study the effects of inflation on accounts and suggest remedial measures. The committee presented its report to the British parliament in September 1975 which spot lighted certain
concepts very dominantly. In fact Sandilands Committee has given a magnificent base in the concept of "current cost accounting" on which very useful system can be developed to suit the changing environment in the entire financial world.

The main recommendations of Sandilands Committee have been briefly stated below. The discussion have, for the convenience of the study been divided into four parts of viz. -

(A) Definitions
(B) Limitations of the historic system of accounts
(C) Current purchasing power method and its limitations
(D) Current cost accounting and its limitations.

(A) **Definitions:**

**Holding Gains:**

A holding gain is the difference between the measured value to a company of an asset at any point of time and the original cost incurred by the company in purchasing that asset. Such gains may be either realised or unrealised. This value to the business of an asset on a particular point of time will be arrived at in the light of guidelines sent by management after due deliberations.
Operating Gains:
An operating gain is the difference between the amounts realised for a company's output (its earnings from goods or services provided) and the value to the business of the inputs used by the company in generating those amounts. A company's profits should be equated with its operating gains.

Extraordinary Gains:
An extraordinary gain is the difference between the amounts realised for items which do not form part of a company's normal output and their value to the company at the time of disposal. The distinction between operating and extraordinary gains is essential for the adjustment and operation at the time of presentation.

Realised Gains:
Total gains may either realised or unrealised during the year. A realised gain is a gain arising from sale or disposal by the company of any kind of goods, services, assets or liabilities.

Unrealised Gains:
"Unrealised Gain" arises when measured value of any asset held by company increases and asset is still retained by the company.
During a period of inflation the value of assets, measured in terms of monetary units rises and as a result, there is an increase in their holding gains when the rate or inflation is high, the holding gains made by companies may be very high.

Holding gains are different in character from operating gains and they should be shown separately in accounts in order to give an overall true and fair view of company's position.

(B) Limitations of Historical Cost Accounting:
While historic cost accounting has no doubt, proved of great value in the past and still retains its greater value and usefulness in all circumstances where it is desired to measure a company's performance in terms of costs incurred and when prices are stable. The usefulness of historical cost accounts is greatly reduced during a period of inflation. There are two main factors responsible for this and which put limitations on historical cost accounts.

1. Historic cost accounts in their basic form do not recognise unrealised holding gains. Assets are shown in the accounts at cost less depreciation and as such the unrealised holding gains arising from the increase in monetary value of assets due to
inflation are not shown. This deprives the users of accounts, viz. shareholders, employees, creditors management etc. from getting useful information on a type of gain which is increasingly important during a time of inflation. To obviate this, some companies have started showing assets (particularly property assets) at a valuation on major accounts but unfortunately there has been no uniform treatment of such valuation by different companies with the results that useful and meaningful comparison of the accounts of these companies is difficult.

2. Under the historic cost accounting, realised holding gains are usually included together with operations gains as profit for the year when due to inflation holding gains are large. This factor reduce the usefulness of historic cost accounts since they do not give the correct information required by users of accounts. This results in exaggerated profit being shown by historic accounting methods due to the valuation of the same quantities of closing stocks at higher level in successive years of inflation. If for example, a company maintains a consistent stock which was valued at Rs.1 lakh at the end of one of the past year and which due to progressive inflation during the last several years now stands
valued at Rs. 8 lakhs. This will have an important and major impact. This progressive valuation of closing stock at higher amounts will result in acute shortages of funds and profit shown will not be there in real terms.

3. The aim of calculating and charging depreciation under historic cost accounting is to spread the cost of an asset over its useful life. The depreciation so charged is inadequate because it does not take into account the changes in the replacement value of the fixed assets under inflationary conditions. The depreciation provided for at a reduced rate may be totally inadequate to purchase a new machine the cost of which would have appreciably gone up. It follows that the profits shown by the company during this period were over stated and that they did not truly reflect the surpluses from the business activities after maintaining the capital assets intact.

(C) **Current Purchasing Power Method**:

In 1974, the professional bodies of accountants in the U.K. recommended that supplementary statements be prepared and attached to the basic accounts of companies to show the various items of financial statements in terms of the value of the pound as at the end of the period to
which they relate. A general price index is used for this purpose since it is the best indicator of the changes in the purchasing power of money as a whole. As the values in historical pounds are to be converted into pounds of purchasing power as at the end of the period, two index numbers are required one showing the general price level at the end of the period and the other reflecting the same at the date of transaction. The method is illustrated below:

An asset was purchased on 1.12.70 at a cost of Rs. 2 lakhs. Determine its value on 31.3.74 assuming that the price index number on 1st Dec. 1970 and 31st March 1974 were 180 and 255 respectively.

Value of the asset on 31.3.74 in terms of current purchasing power as :-

\[
\text{Rs. } \frac{200000 \times 255}{180} = \text{Rs. } 2,83,333
\]

The current purchasing power method has performed a valuable service in the short term of making companies more aware than previously, that inflation can have significant effects on their results. Sandiland's committee, however, pointed out the following limitations of the method:-

1. In long term, the CPP method does not remedy the deficiencies of historical cost accounting and
so it does not provide the best long term solution to the problem of accounting for inflation.

2. The retail price index is an index of prices of wide range of goods and services purchased by domestic consumers. In many cases, such an index will have a misleading indication of the effects of inflation on individual companies.

3. The method introduces a new set of problems by expressing company accounts in a new unit of measurement viz. units of current purchasing power instead of monetary units. The units of current purchasing power is likely to be conceptually difficult for most users of accounts to understand.

4. The recommendations that CPP statement should be supplementary to the basic accounts weakens their impact.

However the CPP method is in use of several companies in India. An illustrative statement taken from ICMA, London publication on SSAP No.7 Accounting for changes in the purchasing power of money is reproduced below:

Accounting for changes in the purchasing power
of money summary of results and financial position adjusted for the effects of inflation.

NOTE-1

<table>
<thead>
<tr>
<th>Historical basis</th>
<th>£000</th>
<th>CPP basis</th>
<th>£000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last year</td>
<td></td>
<td>this year</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

Results for the year
Sales
Profit before taxation
See Note-2
Taxation
Profit after taxation
Dividends

Financial position at the end of year
Net current assets
Fixed Assets
Loss Dep.

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1920</td>
<td>2110</td>
<td>2190</td>
<td>2134</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>205</td>
<td>215</td>
<td>175</td>
<td>195</td>
</tr>
<tr>
<td>Taxation</td>
<td>82</td>
<td>86</td>
<td>86</td>
<td>89</td>
</tr>
<tr>
<td>Profit after taxation</td>
<td>123</td>
<td>129</td>
<td>89</td>
<td>106</td>
</tr>
<tr>
<td>Dividends</td>
<td>60</td>
<td>60</td>
<td>61</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td>63</td>
<td>69</td>
<td>28</td>
<td>41</td>
</tr>
<tr>
<td>Loss Dep.</td>
<td>558</td>
<td>566</td>
<td>700</td>
<td>714</td>
</tr>
<tr>
<td></td>
<td>1048</td>
<td>1122</td>
<td>1261</td>
<td>1257</td>
</tr>
<tr>
<td>Loan capital</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>216</td>
</tr>
<tr>
<td>See Note-3</td>
<td>39</td>
<td>239</td>
<td>44</td>
<td>44</td>
</tr>
<tr>
<td>Total equity</td>
<td>809</td>
<td>878</td>
<td>1017</td>
<td>989</td>
</tr>
</tbody>
</table>
Ratios:
Earnings per share 24.6 25.8 17.8 21.2
based on 5000
shares in issue

Dividend cover
(times) 2.1 2.2 1.5 1.6

Return on total
equity interest % 15.2 14.7 8.8 10.7

Net assets per
share (£) 161.8 175.6 203.4 197.8

Notes:
The figures in the current purchasing power basis
columns were arrived at by converting the corresponding
figures in the historical basis columns by reference to
the changes in general price index between the dates of
original transactions and the end of "This year". The current
purchasing power basis figure for both this and last year
are measured in pounds of purchasing power at the end
of this year. The general price index used was that specified
in provisional statement of standard Accounting Practice
No.7. The retail price index at the end of this year was
139.3 and at the end of the last year. Both figures are
based on Jan.74 = 100. As the inland revenue do not at
present accept CPP basis accounting taxation liabilities
are calculated by reference to profits on the historical
basis and no adjustment. Therefore is made to the tax charge
in CPP basis column.
### Note-2

<table>
<thead>
<tr>
<th></th>
<th>This year</th>
<th>Last year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before taxation (historical basis) Adjusted to convert to CPP basis.</td>
<td>215 000</td>
<td>205 000</td>
</tr>
<tr>
<td>Stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional charge based on restating the cost of stock at the beginning and of the year in pounds of CPP thus taking the inflationary element out of the profit on the sale of stocks</td>
<td>(37) 000</td>
<td>(25) 000</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Additional depreciation based on cost, measured in pounds of CPP of fixed Assets</td>
<td>(25) 000</td>
<td>(17) 000</td>
</tr>
<tr>
<td>Monetary Items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net gains in purchasing power resulting from the effects of inflation on the Co's net monetary liabilities Sales, purchases and all other costs, these are increased by the change in the index between the average date at which they occured and the end of the year, this adjustment increases profit as sales exceeds the costs included in this heading</td>
<td>12 000</td>
<td>10 000</td>
</tr>
<tr>
<td>Profits before taxation (CPP basis at end of year under review)</td>
<td>175 000</td>
<td>180 000</td>
</tr>
</tbody>
</table>
This year  Last Year
£000  £000

Adjustment required to update last year's profit from last year's pounds to this year pounds

Profit before taxation (CPP basis end of this year)

175  195

3. The loan capital at the beginning of this year amounted to £2,00,000, £2,00,000 at the beginning of this year is equivalent in purchasing power to £2,16,000 at the end of this year (because inflation has been 8% during the year). As the Co's liabilities to the providers of loan capital is fixed in money terms this liability has declined during the year in real terms from £2,16,000 to £2,00,000. This reduction of £16,000 in the Co's obligation in terms of current purchasing power is included in the net gain on monetary items of £12,000 shown in Note-2.

(D) Current Cost Accounting:

Main features:

1. Accounts will continue to be drawn up in terms of monetary units.

2. Accounts should show the value to the business of the company assets at the balance sheet date.
3. Profit for the year should consist of Co's operating gains. Extraordinary gains may be shown as profit but should be distinguished from operating gains.

4. Accounts drawn in this way should become basic published accounts of companies. In addition the net book value of assets and depreciation for the year on a historic cost basis should be shown in notes to the accounts.

5. Companies should include in their accounts summarily statements of total gains for the year, showing separately their operating gains (current cost profit) extraordinary gains and holding gains (including stock appreciation).

As a technique of inflation accounting CCA has gained worldwide acceptance. In Holland, for example, Philips, have been preparing accounts and reporting their results on the basis of CCA for the last many years. In U.K. the Accounting standards committee (Exposure Draft 18 of Accounting Standards Committee) has recommended that the published financial statements of companies listed on the stock Exchange should include a separate statement showing the important CCA computations for accounting periods ending on or after December 31, 1977. The concept has also been accepted in the U.S.A. In India a few companies to name (Bharat Heavy Electricals Ltd. and Hindustan Earth
Movers) have included in their annual reports a statement showing the impact of inflation on their accounts. However, many companies in the country compile inflation adjusted figures for their internal management use.

A Brief summary of the major working recommendations of Sandilands Committee and Accounting Statement Committee (Exposure Draft 18) is given:

The Balance Sheet:

The value to the business of any asset owned by a company is the loss the company would suffer, if it were deprived of the asset. In the great majority of cases, this is equal to the amount it would cost the company to replace the asset in its existing condition. It will normally be appropriate, therefore, to value assets in the balance sheet by reference to this current replacement cost (allowing for depreciation where appropriate) taking any holding gains arising to a fixed asset revaluations reserve.

In the context of the above recommendations of the committee, the concepts of gross and net current replacement costs are important. The gross current replacement cost of an existing asset is usually signified by the cost that would have to be incurred to obtain and install at the date of the valuation, a substantially identical new asset in
new condition. It follows that to work out the gross current replacement cost of an existing machine which can be replaced only by a technologically advanced machine, certain adjustments would be required. The net current replacement cost of an existing asset is that part of the gross current replacement cost which reflects its unexpired service potential.

In certain circumstances, the "value to the business" of an asset will be equivalent to its net realisable value or its economic value (defined in the Sandilands Committee report as the discounted net present value of all future earnings expected to arise from possession of the asset).

The value to the business of land and building occupied by the owner himself will normally be the open market value for their existing use, estimated acquisition costs. If however, an open market valuation of the property as a whole cannot be made, the depreciated replacement cost of the building and the open market value of land including the estimated acquisition costs for its existing use should be taken as their value to the business.

The valuation should be made by professionally qualified valuers at an interval of not more than 5 years. In the year between full scale professional valuation, the directors should estimate the value of Land & Building after
consultations with professional valuers, taking into account market variations and changes in construction cost.

Plant & machine, motor vehicles office equipment, fixtures & fittings, ships and aircrafts should normally be valued at their net current replacement cost. For this purpose the gross current replacement cost may be calculated by reference to one or more of the following sources of data.

1. Suppliers' official price list, catalogues etc. with appropriate deductions for trade discounts.
2. The company's own replacement cost estimates based on expert opinion.
3. An index compiled by the company from its own purchasing experience.
4. Authorised external price indices analysed by using industry.

Investments which are not held as current assets should also be shown in Balance sheet at their value to the business. Quoted investments should normally be valued either on the basis of current cost net worth of the company in which the investments have been made or on the basis of the present value of the likely further income from the unquoted investments.
A different treatment is to be given for investments which are held as current assets and for investments in subsidiaries.

Debtors, cash and current liabilities should continue to be shown in the balance sheet at their net realisable value as at present. However, in a period of inflation a business loses purchasing power by holding monetary assets like debtors and cash, it gains by holding monetary liabilities because creditors have to be paid a fixed account, despite inflation and consequential loss in purchasing power of the monetary liability. To show the gain or loss on holding monetary liabilities and assets, a statement should be prepared by way of a note to the account under current cost accounting. Such gains or losses are not included in the profit. However, the effect on the shareholders interest (whether beneficial or adverse) arising from a company financing its activities in part by borrowing during a period of inflation with show through in a current cost balance sheet. The reason for this is that any holding gains which arise on assets financed by borrowings will be credited to the shareholders interest, while the company liabilities will remain unchanged.

The Profit and Loss Account:

In the profit and loss account prepared on the
basis of current cost accounting, two items of expenses viz., depreciation and cost of sales are basically different as compared to the profit and loss account prepared as per the historical cost conventions.

The figure for depreciation charge should be a proportion of the figures of the value to the business of assets shown in the balance sheet, rather than a proportion of their cost.

It follows that the depreciation charge should reflect the value to the business of the assets consumed during the period. It may, therefore, be charged on the average of opening current value and the closing current values of fixed assets. It can also be based on end of period values if this does not produce a materially different charge from the figures calculated on average value.

In an inflationary period, additional depreciation is required to be charged to cover the backlog of depreciation of the gross current replacement cost of the asset that increase every year. Such backlog of depreciation should be charged against the related revaluation surplus rather than to the profit and loss account.

The value to the business of stocks and work in
progress is the lower of current replacement cost or net realisable value. The current replacement cost and the net realisable value of separate items or groups of items of stock and WIP should be found out and the lower of the two values for each item or group of items should be used for the purpose of valuing stock & W.I.P.

Stock appreciation should be removed from the profit and loss account and taken to a reserve by making a "Cost of Sales" adjustment in the profit and loss account designated to ensure that the profit and loss account is debited with value to the business of stock at the time when it is consumed and not with its historic cost. In practical situation, it would be impossible to work and the current cost of sales of each individual item of stock. In majority of cases, however, a sufficiently precise adjustment may be calculated by charging the quantity of stock consumed at the average purchase price of stock during the year.

**Advantages of current cost Accounting:**

Sandiland's committee has pointed out the following advantages of current cost Accounting:-

1. The principle of showing assets, and liabilities at their "value to the business" will enable the comparative returns on capital employed of different
companies to be assessed in a more useful way during a time of inflation that is not possible with the existing accounting conventions.

2. The clear separation in the accounts of holding operating and extraordinary gains will lead to clear distinction being made between gains which due to a Co's productive efforts and gains due to luck or skill in timing of purchase of assets during a period of inflation. Such accounting presentation will enable the performance of companies to be assessed and compared in a more useful way then with existing methods which do not make such distinction. It is also particularly important for internal management purposes during a period of inflation to have information which clearly distinguishes between operating and holding gains.

3. The principles of current cost accounting are developments of accounting techniques already in use by number of companies. For example the revaluation of property assets in company accounts is already widespread and the principles underlying the "Cost of sales" adjustment forms the baiss of the base stock method of accounting for stock. CCA is an evolutionary rather than a revolutionary system of accounting.
Illustrations:
Cost of sales adjustment or COSA:

Method:
1. Average current cost of closing stock is found out in the following manner :-

(i) Closing Stock x Average Index Number
    Closing Index Number

(ii) Average current cost of opening stock
    = Opening Stock x Average Index Number
    Opening Index Number

(iii) Average current cost of closing stock :-
    Average current cost of opening stock
    = Cost of Sales Adjustment

Formula for finding out cost of sales Adjustment:

\[ \text{COSA} = (C-O) - Ia \left( \frac{C}{IC} - \frac{O}{IO} \right) \]

Index number on 1.1.88 - 200
Average index number - 250
Closing index number - 300
Opening stock on 1.1.88 - Rs. 50,000
Closing stock on 31.12.88 - Rs. 90,000
Purchasing during the year - Rs. 10,00,000
COSA = \( (C - O) - Ia \frac{C - O}{IO} \)

\[ \begin{align*}
= & \ (90,000 - 50,000) - 250 \frac{(90,000 - 50,000)}{300} - 200 \\
= & \ 27,500 \\
\end{align*} \]

**Monetary working capital adjustment (MWCA)**

Monetary WC = Trade Debtors + B/R + Repayments +
Amount of that stock which has not been included in cost of goods sold
- (Trade creditors + B/P + the part of Bank overdraft which is related with stock)

In case of Banks & other financial institutions even those liabilities and assets are also included in Monetary working capital, which are related with the operating activities of business.

1. Monetary Working Capital of the beginning of the concerned year is calculated according to above method.

2. Monetary working capital at the end of the concerned year is found out according to above method.

3. Deduct the MWC of the end of the year from the MWC of the beginning of the year or concerned period.
4. Above two MWC are adjusted with general prices as under :-

(a) Opening MWC \times \frac{\text{Average Index Number}}{\text{Opening Index Number}}

(b) Closing MWC \times \frac{\text{Average Index Number}}{\text{Closing Index Number}}

\text{Deduct} = (b) - (a)

5. The amount found out as per (4) above is deducted from the amount found out as per (3) above and thus the amount found out is regarded as MWC adjustment. It is just like one which is used in connection with the adjustment of cost of sales.

\text{MWCA} = (C - O) - I_a \left( \frac{C - O}{I_c I_O} \right)

- \text{C} = \text{Closing balance of MWC}
- \text{O} = \text{Opening balance of MWC}
- \text{I}_a = \text{Average index number for the period}
- \text{I}_c = \text{Index number for CMWC}
- \text{I}_O = \text{Index number for OMWC}.

Index no. on 1.1.88 - 400
Index no. on 31.12.88 - 500
On 1.1.88 opening balance of debtors, B/R, creditors, and bills payable respectively are Rs. 60,000, Rs. 40,000, Rs. 40,000 and Rs. 10,000. On 31.12.88 closing balance of debtors, B/R, creditors and B/P respectively are Rs. 65,000, Rs. 45,000, Rs. 35,000 and Rs. 10,000. Average index for the year 1988 is 450. Find MWCA - closing balance of MWC=(65,000+45,000)-(35,000+10,000) = Rs. 65,000

Opening balance of MWC = (Rs.60,000-40,000) - (40,000+10,000)
= Rs. 50,000

MWCA = \frac{(C - O) - Ia}{IC} (C - O)
= \frac{(65,000-50,000)-450}{500} \left( \frac{65,000 - 50,000}{400} \right)
= 15000 - 450 (130-125)
= 15000 - 2250 = Rs. 12,750

**Gearing Adjustment:**

If the amount of adjustment of cost of sales the amount of adjustment of MWC and the amount of additional depreciation are recorded in profit and loss account then profit or loss disclosed by profit & loss account is affected by these amounts therefore one more adjustment of the total of these amounts is made. It is known as Gearing Adjustment:

\[
\text{Gearing Adjustment} = L \times \frac{TA}{L+S} \\
\text{(GA)}
\]
GA = Gearing Adjustment
L = Net Borrowings
S = Shareholder's fund
TA = Total of adjustment amounts of COSA, MWCA and additional depreciation.

Net Borrowing:

All the liabilities and provisions expressed in money are added. Convertible debentures and deferred tax are also included, but proposed dividends are excluded. It must be noted that in all liabilities & provision those liabilities are not included which are used for finding out MWC and equity capital is also not included. From the total of above amounts, following are deductible and the balance is called net borrowing.

Total of all assets except those current assets which are used in the adjustment of cost of sales & MWC.

Illustration:

On 1.1.88 the amounts of share capital, debentures long period loan & cash respectively were Rs. 3,00,000 Rs. 1,80,000, Rs. 50,000 and Rs. 30,000. On 31.12.87 amounts of share capital, debenture, long period loan and cash respectively were Rs. 3,50,000, Rs. 2,00,000, Rs. 60,000 and Rs. 40,000.
Adjustment for cost of sales Rs. 35,000, Adjustment for monetary WC Rs. 40,000 and additional depreciation Rs. 7000. Find out GA.

Gross Borrowing on 1.1.88 = Debentures Rs. 1,80,000+
Long period loan Rs. 50,000 = Rs. 2,30,000.

Net Borrowing on 1.1.87 = Rs. 2,30,000-Cash
Rs. 30,000 = Rs. 2,00,000

Cash has been deducted because it does not enter in determining MWCA.

Shareholder's fund on 1.1.87 Rs. 3,00,000
On 1.1.87 Total of Net Borrowing & Shareholder's Fund = Rs. 2,00,000 + Rs. 3,00,000 = Rs. 5,00,000

Gross Borrowing on 31.12.87 = Rs.2,00,000+Rs.60,000
= Rs. 2,60,000

Net Borrowing on 31.12.87 = 2,60,000 - Cash Rs.40,000
= Rs. 2,20,000

Shareholders' fund on 31.12.87 Rs. 3,50,000
Total net borrowings & shareholders' fund on 31.12.88
= Rs. 2,20,000 + Rs. 3,50,000 = Rs. 5,70,000
Total of Adjustments = COSA Rs.35,000 = MWCA Rs. 40,000
+ Add. Dep. 7000 = Rs. 82,000

\[ \frac{L}{L+S} \times TA = \frac{\text{Rs.2,00,000} + 2,20,000}{\text{Rs.5,00,000} + 5,70,000} \times 82,000 \]

= Rs. 32,187 approx.

Example of Presentation of current cost accounts
(Taken from Statement of Standard accounting practice No.16 on current cost Accounting prepared by ICMA London)

X Limited and Subsidiaries
Group current cost profit & loss
A/c for year ended on 31st Dec.1980

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>18000</td>
</tr>
<tr>
<td>1980</td>
<td>20000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Turnover</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>......................</td>
</tr>
</tbody>
</table>

Profit before interest and taxation

on the historical cost basis

Less: Current cost operating adjustments

(Note-2)

<table>
<thead>
<tr>
<th>Description</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current cost operating profit</td>
<td>1390</td>
<td></td>
</tr>
<tr>
<td>Interest payable less receivable</td>
<td>180</td>
<td>1190</td>
</tr>
<tr>
<td>Taxation</td>
<td>610</td>
<td>730</td>
</tr>
<tr>
<td>Current cost profit after interest &amp;</td>
<td>310</td>
<td>460</td>
</tr>
<tr>
<td>taxation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
170  Gearing adjustment
480  Current Cost profit attributable to shareholders
400  Dividends
80  Retained current cost profit of the year

16.0 P  Current cost earnings per share
        operating profit return on the
        average of the net
5.2%  Assets

60%  

**Statement of retained profit/reserves**

<table>
<thead>
<tr>
<th>£'000</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>80</td>
<td>196</td>
</tr>
<tr>
<td>1850</td>
<td>2054</td>
</tr>
<tr>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>1930</td>
<td>2250</td>
</tr>
<tr>
<td>14150</td>
<td>16080</td>
</tr>
<tr>
<td>16080</td>
<td>18330</td>
</tr>
</tbody>
</table>

**X Limited and Subsidiaries**

**Summarised group current cost balance sheet as at 31.12.80**

<table>
<thead>
<tr>
<th>£'000</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>18130</td>
<td>Assets employed:</td>
</tr>
<tr>
<td>1980</td>
<td>19530</td>
</tr>
</tbody>
</table>
### Net current assets:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>4000</td>
</tr>
<tr>
<td>Monetary W. Capital</td>
<td>800</td>
</tr>
<tr>
<td>Total working capital</td>
<td>4800</td>
</tr>
<tr>
<td>Proposed Dividends</td>
<td>(430)</td>
</tr>
<tr>
<td>Other current liabilities (Net)</td>
<td>(570)</td>
</tr>
<tr>
<td>2900</td>
<td>3800</td>
</tr>
<tr>
<td>21030</td>
<td>23330</td>
</tr>
</tbody>
</table>

### Financed by:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
<td>3000</td>
</tr>
<tr>
<td>Current cost reserve</td>
<td>14404</td>
</tr>
<tr>
<td>Other reserves &amp; retained</td>
<td>3926</td>
</tr>
<tr>
<td>Profit</td>
<td>21330</td>
</tr>
<tr>
<td>Loan capital</td>
<td>2000</td>
</tr>
<tr>
<td>21030</td>
<td>23330</td>
</tr>
</tbody>
</table>

**X Limited and Subsidiaries**  
Notes on current cost accounts for the  

**Year ended 31.12.80**
1. Adjustments made in deriving cost operating profit:

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£000</td>
<td>£000</td>
</tr>
<tr>
<td>400 Cost of sales</td>
<td>70 Monetary W.C.</td>
<td>470 Working Capital</td>
</tr>
<tr>
<td>460</td>
<td>100</td>
<td>560</td>
</tr>
<tr>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>2. Fixed Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31st Dec. 1980</td>
<td>1979</td>
<td></td>
</tr>
<tr>
<td>Gross</td>
<td>Dep.</td>
<td>Net</td>
</tr>
<tr>
<td>£000</td>
<td>£000</td>
<td>£000</td>
</tr>
<tr>
<td>Land &amp; Building</td>
<td>3780</td>
<td>680</td>
</tr>
<tr>
<td>Plant &amp; Machinery</td>
<td>25,780</td>
<td>9350</td>
</tr>
<tr>
<td>29560</td>
<td>10030</td>
<td>19530</td>
</tr>
<tr>
<td>3. Current cost reserve:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance at 1.1.88</td>
<td>£000</td>
<td>£000</td>
</tr>
<tr>
<td>Revaluation surpluses reflecting price change</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land &amp; Building</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Plant &amp; Machinery</td>
<td>1430</td>
<td></td>
</tr>
<tr>
<td>Stocks &amp; W.I.P.</td>
<td>490</td>
<td></td>
</tr>
<tr>
<td>Monetary working capital adjustment</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Gearing adjustment</td>
<td>(166)</td>
<td></td>
</tr>
</tbody>
</table>
Balance at 31.12.80

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>14,404</td>
</tr>
<tr>
<td>of which: realised [see (iii) below]</td>
<td>2,494</td>
</tr>
<tr>
<td>Unrealised</td>
<td>11,910</td>
</tr>
</tbody>
</table>

(i) where applicable, surpluses or deficits arising on the following should be shown as movements on reserves.

(a) the revaluation of investments (other than those included in current assets);

(b) the re-investment in associated companies and

(c) consolidation differences arising on foreign currency transaction.

(ii) where relevant movements should be shown net of minority interest.

(iii) the realised element represents the net cumulative total of the current cost adjustments which have been passed through the profit and loss account including the gearing adjustment.

4. **Financing of net operating assets:**

The following is the value to the business (normally current replacement cost net of depreciation on fixed assets) of the net operating assets at the balance sheet date, together
with the method by which they were financial.

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
<th>1978</th>
<th>1980</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fixed Assets</td>
<td>£18,130</td>
<td>£19,530</td>
</tr>
<tr>
<td></td>
<td>Working Capital</td>
<td>£3,900</td>
<td>£4,800</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£22,030</td>
<td>£24,330</td>
</tr>
<tr>
<td></td>
<td>Share capital &amp; reserves</td>
<td>£19,080</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Proposed dividends</td>
<td>£400</td>
<td>£430</td>
</tr>
<tr>
<td></td>
<td>Total shareholders' interest</td>
<td>£19,480</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Loan Capital</td>
<td>£1,950</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other current liabilities</td>
<td>£600</td>
<td>£570</td>
</tr>
<tr>
<td></td>
<td></td>
<td>£2,550</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>£22,030</td>
<td>£24,330</td>
</tr>
</tbody>
</table>

**CONCLUSION:**

Inflation Accounting is to highlight the impact of inflation on operation of a company by distinguishing between operating gains and holding gains. Extraordinary gains are also to fall conspicuously under a separate category. The above method is also not far from criticism. There remains more scope for subjective judgement in accounts than there has been hitherto.
From the above discussion it is clear that none of the methods of inflation accounting free from criticism. Although one method may have edge over the other still. The value of organisation and country's overall condition shall help in determining the suitable method of adjustment.

In the next chapter of my thesis, I have analysed the cases according to the CPP method which basically depend upon selection & choice of index numbers. In my earlier Chapter I have made certain observations and recommendations with the help of which we may overcome the short-comings of CPP method of inflation adjustment in the books of accounts.
REPLACEMENT VALUE THEORY:
A PRACTICAL APPLICATION

By J.P. Snoek

In this present day and age it is generally understood and accepted that inflation, in the long run, has a devastating effect on the economy of any country. Governments therefore find themselves forced to take drastic and usually unpopular measures like price and wage controls to try curb inflation. The necessity for such action in an effort to break the wage/price spiral, is although reluctantly accepted as inevitable by the business community and also the public at large appreciate that what is gained on the swings of wage increases is lost on the round-about of price rises so that in the end nobody is better off.

Nowadays the businessman cannot afford to be ignorant about the problems associated with inflation. He knows that the only way to recover increases in prices of labour (wages) and materials is to increase his selling prices, unless he can achieve improved productivity or is prepared to accept lower profits.

It is surprising, therefore, to find so many managers (and, for that matter, accountants), so alert when it comes to recognising and counteracting the short term effects of

* Mr. J.P. Snoek was the Finance Director, Philips Electrical Industries of New Zealand.
inflation in the form of rises in the cost of labour, materials and services, but who turn a completely blind eye to its long term effects in the form of rises in the cost of assets. They are all aware that continually rising prices endanger the future of a country macro-economically by eroding the purchasing power of its currency, but fail to take cognisance of the fact that this very same phenomenon puts in jeopardy the continuity of their own company by the erosion of the purchasing power of its shareholders' funds.

That this danger is not imaginary or just an interesting theory but very real, is demonstrated in the example shown in chart form. In this it has been assumed that an asset costing $1,000 at the time of purchase and to be depreciated on the straight line method in 5 years, shows an increase in price of 10 per cent per year. When the increase in replacement cost is ignored and the asset is depreciated on historical cost basis only, the accumulated depreciation will be considerably shorter and insufficient to replace the asset at the end of the 5-year period.

In other words, the purchasing power of the capital applied to acquire the asset at the beginning of the period has not been maintained and additional funds must be found for a replacement. To us in Philips this is not acceptable and, for reasons outlined below, we apply the replacement
value theory, not only with regard to fixed assets but to all items in which the Company's capital is invested.

Before outlining the practical application of the replacement value theory in the Philips concern, it is necessary to give some attention to the background against which the theory is used, and the principles upon which the accounting system is based.

In the Netherlands the basis from which both economic and accounting principles and conventions have evolved is 'Sound Business Practice'. This theory has found wide acceptance there over a period of some 50 years, not only with Philips but also with many other organisations.

It is maintained that the Company as an independent organism, aims for continuity. When this is accepted as a basis it follows automatically that goods and services sacrificed in producing an income have to be replaced and hence, have to be valued at replacement value and not historic cost. Continuity, however, is secured only when the enterprise is maintained as an economic potential which is interpreted as the necessity to maintain the purchasing power of its capital.

At Philips, therefore, there is no recognition of
income for a period unless the capital employed in the business at the beginning of the period has been maintained. This means, until after it has been established that the purchasing power of that capital at the end of the period is equal to that at the beginning of the period.

The replacement value theory derives its importance from the economic phenomenon of changing price levels which may be either of a specific nature (certain commodities), or a general (arising from the purchasing power of money). This raises problems of valuation and their effect on the calculation of income and capital. A distinction has, to be made between changes of a capital nature, which economically do not form part of the income, and income itself. The income itself must then be further divided into operating income, revenue, and expenses of a sundry or incidental nature.

Development of Replacement Cost and Accumulated Depreciation of Asset to be Depreciated in 5 years. Increase in price 10 percent per year.
A - accumulated depreciation of historic cost
B - accumulated extra depreciation of previous years
C - extra depreciation this year
D - total accumulated depreciation on basis of replacement value.

The operating income of an enterprise during a certain period is properly effected in the income statement only if it shows the revenue of the period and the cost which has been incurred to produce it. In order to assure the continuity of the enterprise, all costs incurred must be included at their replacement values, and not at the prices which actually may have been paid. In this context it is irrelevant whether or not replacement is actually taking place at the moment the cost is incurred.

The difference between the proceeds of goods sold and the cost to be incurred to reproduce them at the time of exchange determines the operating income. The difference between historic cost and the cost of replacement basis has to be set aside to enable the enterprise to replace and so secure its continuity, therefore, it cannot be regarded as income.

A brief description of the accounting system in which the theory is applied is necessary for a proper understanding of the degree to which the theory is imbedded in the decision making process at all levels of management.
The object of the accounting system is to provide management of each section of the Company with the information it requires for operating that particular section and to provide the top management with the information required for its central management.

The system is organised in accordance with a system of budgetary control which implies the existence of norms and standards.

The system is decentralised; each section of the company has its own accounting department producing a monthly balance sheet and income statement.

From the monthly statements, the income and the capital employed, both in total and in detail, are available to the responsible managers at all levels. For this purpose, the replacement value theory is applied so that it is integrated in the accounting system of all sections at every stage and not merely used as a calculating technique for preparing annual statement. Thus, it is ensured that the replacement value automatically enters into all management considerations and decisions.
PRACTICAL APPLICATION

For a detailed explanation of the application of the replacement value theory, particularly of the way in which the replacement value is determined and its implementation in the accounts, the starting point will be the various items making up the capital and based on the following classification of the balance sheet:

**BALANCE SHEET**

At the Beginning of the Period

<table>
<thead>
<tr>
<th></th>
<th>Fixed assets, stocks, intangible assets and investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders' equity</td>
<td>a</td>
</tr>
<tr>
<td>Liabilities</td>
<td>b</td>
</tr>
<tr>
<td>x</td>
<td>d</td>
</tr>
</tbody>
</table>

Fixed assets, stocks, intangible assets and investments are revalued according to the procedures set out below. Purchasing power of net monetary assets (d-b) will diminish in times of inflation and the method to provide for this, requiring a different technique, is commented on separately.

**Fixed Assets:**

For fixed assets the revaluation calculations are
based on the trend of specific price levels and not of the general price level. The trend of prices for buildings, dwelling house, machinery, etc. is followed separately. Building for instance, will be revalued according to index figures for the cost of the particular type of building under consideration. This will be followed up by independent valuations periodically (in times of rapidly increasing price levels at present, once a year or, if necessary, even more frequently) to ensure that the replacement value in our books is in line with current price levels. Machines can be revalued on the basis of current market prices or, if manufactured in the Company's own factories, on the basis of current costs.

Revaluation normally are carried out once a year, unless price fluctuations are significant. However, should larger fluctuations occur during the year, for example, devaluation, sales tax increases, the assets affected will be revalued immediately.

In connection with the revaluation of fixed assets, the following accounts are maintained:

(1) Fixed assets at replacement value.
(2) Depreciation of fixed assets at replacement value.
(3) Revaluation of fixed assets.
(4) Cost of depreciation of fixed assets.
The accounts under (1) and (2) belong to the group of fixed assets accounts, (3) is a shareholders' funds account and (4) is an income account. By entering every revaluation into the accounts, the cost account (4) will be charged automatically for the depreciation on the basis of replacement value, since the depreciation is a function of the replacement value of the assets and their estimated technical or economical lives.

When price increases occur, the following entries take place for the uplift in value:

Dr (1) Fixed assets
Cr (3) Revaluation of fixed assets

Usually the assets being revalued will have been partly depreciated in previous years and this accumulated depreciation will have to be increased by the same index as applies to the value of the assets themselves. The depreciation account then correctly states the expired life of the assets in terms of their replacement value. The journal entry to give effect to this is:

Dr (3) Revaluation of fixed assets
Cr (2) Depreciation of fixed assets
This revaluation of past depreciation demonstrates that with increases in price level, the depreciation provided in previous years had been too low and must be increased to ensure that adequate funds are available for replacement of the assets at the end of their useful life. Therefore, it should be charged to Income account instead of Revaluation account. This, however, is not done in Philips for the following reasons:

(1) Due to the size of the concern, world-wide, the composition of the total fixed assets as far as lives are concerned approximates an average. As a result, yearly replacement for all practical purposes are equal to the yearly depreciations. The capital invested in Fixed assets therefore always relates to the total of fixed assets of an average life and no provision needs to be made for deferred depreciation.

(2) Against the income account, a fund is being built up to provide for the maintenance of the purchasing power of shareholders' equity invested in monetary assets. The treatment of this will be discussed later.

Stocks:

Within the scope of the application of the budgetary
system standard prices are used for all groups of stocks that is, goods purchased, semi-finished products, and finished products. The starting point for the establishment of the replacement value is the price level which formed the basis for the calculation of the standard price. The trend in the price levels of the various elements of the standard price are closely followed and whenever the fluctuations in these prices are significant enough to justify adjustments of the standard prices, the stocks are revalued, either individually or by way of the application of index numbers.

In view of the large number of individual items making up our total stocks, it would be impossible to follow the price trend for each of those separately. Therefore, prototypes, selected from the total range, each representing a certain group of code-numbers. These prototypes are analysed into the cost elements of raw materials, labour, machine costs, overhead recovery, etc.

When price changes for these cost elements occur, their influence on the total cost price can be ascertained and the index for the prototype can be applied to the group for which it is representative.

Usually revaluations of stocks are carried out once a year, unless the price fluctuations during the year have
not been significant enough to justify a full revaluation of all individual items. Large price changes during the year, however, can make it necessary to revalue stocks immediately or, if not significant enough to justify individual revaluations but too large to ignore, we will apply indices to reflect the changes in prices. Because of the volume of work involved the decision for individual adjustments of prices is taken with some care. Although the computer has taken over much of the work that had to be done manually in the past, a full revaluation is still a major task.

In connection with stocks the following accounts are kept:

(1) Stocks.
(2) Adjustments to reflect changes in index numbers.
(3) Price differences.
(4) Revaluation of stocks.

Accounts (1) and (2) are current assets, (3) is an income account and (4) is a shareholders' funds account.

All stock accounts are kept at standard prices and small differences between the actual purchasing price and the standard price are adjusted to Price difference account. If goes without saying that whenever an index
is applicable to the standard price, the amount booked
to Price difference account consists of the difference between
purchasing price plus or minus this index.

When stocks are revalued individually, the journal
entry will be:
Dr. (1) Stocks.
Cr. (4) Revaluation of stocks.

When the index method is used to reflect the
changed price level, the entry is:
Dr. (2) Index adjustment
Cr. (4) Revaluation of stocks.

after which all stock movements must be taken up at standard
price plus or minus the index by debiting/crediting the
stock account (1) for the standard price and simultaneously
(2) for the index. Using the last index at the end of the
year the revaluation is then calculated for the individual
items of stock.

The amount of revaluation thus arrived at should
be equal to the amount in the Index adjustment account
(2). Any differences (subject to analysis if they are large)
are transferred to income account. The revaluation is now
booked with the entry:
Dr. (1) Stocks
Cr. (2) Index adjustment.
Investments:

For consolidated subsidiaries, the same principles as those adopted in the parent company are followed. As far as other investments are concerned, we recommend that the associated companies also follow these principles as they are appropriate also for internal management policy. In those cases where nevertheless, the principles are not applied, assessments are made on the basis of information received from the associates and the investments are included in our own accounts as nearly as possible in accordance with our governing principles.

Intangible Assets:

Particular mention should be made here of initial costs. These represent expenses made for the development and starting up of production of new products and are recovered over a certain period out of a precalculated volume of production. The revaluation of these assets is similar to that of stocks.

Monetary Assets:

In the foregoing it has been explained how the purchasing power of shareholders' equity invested in the items under C of the form of Balance Sheet, has been maintained by revaluation of these items whenever necessary. Part of shareholders' equity, however, can be invested in monetary assets (liquid assets, debts receivable, prepayments, etc)
and this will be the case when these assets exceed liabilities or, when \( d < b \).

In times of inflation, the purchasing power of that part of the equity will diminish and, as mentioned before, since we believe that there can be recognition of profit only if, after the application of the replacement value theory, the purchasing power of the shareholders' equity has been maintained, a correction will have to be made.

This is done by applying the cost-of-living index to the net monetary position \((d - b)\) and charging the amount arrived at to \( P/L \) account with the entry:

- Dr Cost of inflation (Income account)
- Cr Reserve for diminished purchasing power of capital invested in monetary assets (Shareholders' funds account).

From the foregoing, logically, it should be concluded that in the case of an increase in purchasing power of the currency a profit should be recorded. Here we follow the rule that profits should be recognised only to the extent that past losses of this nature have been shown. This profit is limited therefore to the maximum of the balance of the account, "Reserve for diminished purchasing power of capital invested in monetary assets".
General

Many critics of the application of the replacement value theory have maintained that the same results could be achieved by less complicated and, consequently, cheaper means. In the following, some of these criticism will be examined in detail and refuted.

More and more companies, also in New Zealand, are now realising that assets acquired 20 years ago, have a considerably higher value today than at the time of purchase. Many companies therefore revalue these assets and pass this action off as an acceptance of the replacement value theory. From the foregoing, however, it will be clear that this is only a first step towards acceptance of the theory and, logically, should be followed by adoption of the replacement value as the basis for depreciation. Usually, this step is not taken and the assets therefore continue to be depreciated on the conventional basis, that is, on what is acceptable to the fiscal authorities. Although the revaluation achieves that the balance sheet gives a true picture of the value of the assets, the valuation principles adopted for balance sheet purposes are not consistent with those adopted for the calculation of profit.

With regard to stocks, it has been put that the LIFO method would achieve the same result as the application
of the replacement value theory. This is true as far as income statement is concerned and provided that there is a high rate of turnover of stocks. In the balance sheet, however, the real capital employed is not presented and, as no standard prices based on current price levels are used, no distinction can be made between price differences and efficiency variances in the income statement. Information provided to management is therefore inadequate for decision-making.

The cost connected with the application of the theory is thought by many people to be prohibitive. It is not possible to make exact calculations of the extra cost involved but there is no doubt that the system is more expensive in its execution than conventional systems). The extra cost, however, can be limited to a minimum by the use of modern accounting methods and equipment. What is of far greater importance, however, is the fact that a more appropriate basis for policy decisions is created and the extra cost is certainly negligible compared with this benefit.

Finally, many adversaries of the replacement value theory contend, that, as long as a company retains enough profits, it will have the funds available for replacement and that therefore the ultimate position will be the same
in both cases. This is indisputably true as far as setting aside funds for replacement is concerned but falls short as far as the application and objectives of the theory are concerned in various respects:

(1) It would be difficult to establish at the end of each year how much would have to be set aside by way of retained profit.

(2) When profits are computed on the basis of historical cost they contain element which can not be distributed without endangering the continuity of the enterprise. Even accepting that the amount required for replacement can be established, there is always the risk that, under the pressure of circumstances, too much profit will be distributed by way of dividend.

(3) When the information given periodically to management is based on historical cost, the replacement value does not enter into management considerations and decisions which may have a direct bearing on the income of the enterprise. Selling prices for instance are not only determined by competition but are also based, at least in part, on costs.
Only the application of the theory results in a clear-cut measurement of profits against real capital employed, in which both are based on the same valuation principles. If the capital is not calculated on the basis of replacement value, the profits are measured against a capital which has little economic meaning and the ratios obtained are of little value both to the management of the enterprise and the shareholder.

**Reporting**

In the foregoing it has been made clear that all internal reporting for management at all levels is based on replacement value. It is not only management, however, that requires information on the operation of the enterprise, but also the shareholders are entitled to this information although they require it less frequently and in less detail. In their reporting to shareholders the management renders an account of their stewardship and supplies any other information on the operations and prospects of the enterprise which may be considered useful.

As all management's decisions have been influenced by the application of the replacement value, reporting to shareholders must be on the same basis. The method of calculation of income and capital is therefore the same for both internal and external reporting and no distinction between these is made.
Conclusions:

(1) We are aware that we do not apply the replacement value theory in all its details. Our application can certainly be criticised in some respects, but we believe we have developed a practical application, based on theoretical principles, for a difficult problem.

(2) We are convinced that a better basis for management decisions is created by the application of the theory. The segregation between operating results and changes in capital as a result of change in price level is essential to management and comparisons between income of different periods are unreliable without replacement value.

(3) It is not desirable to make a distinction between internal and external reporting, both must be based on the same premise.

(4) Our belief in the correctness of the application of the replacement value theory is emphasised by our consciously accepting an apparently less favourable picture of our financial position in the annual report as compared with other enterprises which adhere to the traditional method.
(a) In periods of rising prices the profits shown by Philips are less favourable than according to the traditional method.

(b) The net worth is larger and thus the ratio of profit to net worth is lower.

(c) Even if, after distribution of profits, the position according to the replacement value theory would be the same as that according to the traditional method, the latter has been achieved with a larger income and larger retained profits. For the superficial reader this gives a more favourable picture than under the application of replacement value.

SELECTED BIBLIOGRAPHY

CHAPTER-IV


(11) Mason, Perry, Price-Level changes and financial statements - Basic concepts and methods, American Accounting Association, 1956.

(12) May, George O., "Business income and price levels-an accounting study".


