I N F L A T I O N A C C O U N T I N G

and

Present Company Financial Reporting in Kenya

by

Francis Makori Nyagari

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ABSTRACT

Accounting for price-level changes is a current controversial issue in the accounting profession. It has attracted both practicing accountants and academicians in recent years. The writer of this thesis is not an exception to such an attraction. The thesis is built on the basis of the following hypotheses:

1. Conventional historical-cost accounting is deficient in providing relevant and up-to-date information to the users of financial statements. This is particularly so when prices of goods and services are not stable.

2. During a period of rising prices, the original costs and the depreciated book values of fixed assets are understated at any given point in time. The depreciation of fixed assets, calculated on the basis of their understated values, is therefore less than normal. Hence, less depreciation is charged to earnings, this resulting in the overstatement of net operating profits. As a result of the excessively stated net profits, some firms tend to exaggerate the dividends paid to shareholders and some of these dividends are effectively paid out of capital rather than income. Also, the overstated net profits are excessively taxed by the Government. The end result is that less profits are retained by companies for future asset replacements and expansion.

3. The overstated profits during a period of rising prices tend to attract demands for higher wages by labour unions. This process encourages further inflation.

4. Financial information provided by financial statements can be improved tremendously if a new accounting system, which reflects the effects of price changes on business, is introduced to replace conventional historical-cost accounting.

The above four hypotheses are examined in a fairly detailed manner in this thesis. The thesis is divided into five chapters. Chapter One introduces the contents of the thesis. In this chapter, it is revealed that a general rise in prices is a world-wide phenomenon, and that this trend has been observed since the end of the Second World War. Because this upward trend in prices has been persistent for long, and because it still continues, the term "Inflation" has been chosen to describe the trend.

The introductory chapter also gives an over-view of recent developments in the accounting profession with regard to inflation accounting. It is shown that Britain, Australia and United States are in the forefront in the discussion of this controversial subject of accounting.

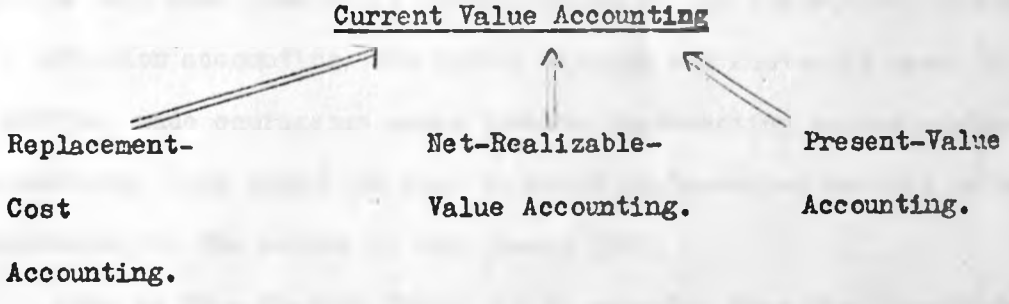
Chapter Two starts by giving a brief discussion of the objectives of financial statements. It is stated that financial statements act as a vehicle for conveying financial information to the users of those statements. To achieve this objective effectively, the financial statements should be updated to show the current values of assets, and the depreciation of fixed assets should be based on these current values. The Chapter also presents the characteristics of historical-cost accounting, which makes a fundamental error by assuming that the value of a shilling is constantly maintained regardless of changes in the general level

of prices. The Chapter also contains illustrative examples of the inadequacies of historical-cost accounting when prices are unstable.

Chapter Three is the largest chapter. It looks at the two proposed approaches to inflation accounting, namely, price-level accounting and current-value accounting. Price-level accounting uses an appropriate general price index to restate the data in the historical-cost financial statements so as to reflect current changes in the general level of prices. Every figure in both balance sheet and income statement is updated using the general price index. This updating can formally be stated as follows:

$$\frac{\text{Historical cost (of asset, etc)}}{\text{Price index at date of acquisition (of asset, etc)}} \times \text{Price Index at date of preparing the financial statements.}$$

Current value accounting aims at stating the current values of financial items at the date of preparing the financial statements. This system values the financial items using any of the three options illustrated below:



'Replacement-cost accounting' values assets with reference to their market replacement costs. In other words, it values the

assets at the costs of replacing them if the firm were to be deprived of them. This method assumes that a firm is a going concern, and that therefore the firm has to replace its assets once they are worn out. 'Net-realizable-value accounting' values assets with reference to their net resale values, after giving allowance for the incidental resale expenses. Thus, unlike the replacement-cost concept, the net-realizable-value concept is based on exit value. Both valuation bases are, however, market-validated bases. 'Present-value accounting' values assets at their existing value to the firm. It discounts the expected future benefits of each asset in order to determine the present value of the asset.

Both Price Level Accounting and Current Value Accounting are dealt with in Section I of Chapter Three, and they are contrasted at the end of this Section. Section II of Chapter Three examines the historical developments within the accounting profession in regard to inflation accounting. It is shown that the United Kingdom, Australia and New Zealand, United States, and Canada have made remarkable contributions to the theoretical discussion of inflation accounting. The United Kingdom and Australia have, in addition, made courageous moves towards implementing current-value accounting. Both countries plan to start implementing current value accounting by the middle of this year, 1977.

Also in this Chapter Three, it is revealed that the developing countries have made negligible contributions towards inflation accounting. It is my hope that such countries will soon follow in the footsteps of the United Kingdom and Australia.

Chapter Four focuses its attention on the accounting practices of companies here in Kenya. The views of various local financial managers and those of the companies studied are presented in this Chapter. It is reported that historical-cost accounting dominates in our local financial reporting. The general view of our local companies is that inflation accounting is necessary, but these companies are not decided on which system should replace historical-cost accounting. It is their contention that current-value accounting should be accepted and implemented at some future date. They, however, fear introducing the system in the near future because they feel they do not have accountants qualified enough to prepare inflation-adjusted accounts.

Finally, Chapter Five, provides a summary of the thesis. This Chapter also gives brief conclusions based on the current developments in the accounting profession. The questionnaire used by the author in carrying out a survey on the local financial reporting is also presented in this Chapter.

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CHAPTER ONE

Introduction

1.1 Inflation as a worldwide Phenomenon

The world over has experienced high rates of inflation in recent years. Prices of goods and services have been soaring at alarming rates, and this has threatened the economic survival of some nations and their people. Now and again we hear of complaints from countries about the increases in prices. Students and workers in Egypt demonstrated against the proposed increases in prices by the Government in January, 1977. The oil-producing countries in the Middle East continue to increase the prices of their crude oil, which in turn forces the oil-importing countries to increase the prices of fuel. The increase in fuel in turn increases costs of transport, costs of production, and finally costs of goods consumed. This acceleration of inflation started at the end of the 1960s. Two factors were probably responsible for this galloping inflation, namely:

1. the disruption of the international monetary system by the U.S. balance-of-payments deficit; and
2. the commitment of post-war Governments to policies designed to ensure full employment. For most countries, the inflation rate reached its peak in the years 1974 and 1975. While developed countries seem to be more particularly concerned about the effects of inflation, the developing countries are also taking measures against inflationary effects. The developed countries have also begun to be more concerned about the effects of inflation on accounting reports. These reports are supposed to give a fair picture of the

results of operations of an entity in each accounting year (reflected in an income statement) and the financial position of the entity at the end of the accounting period (reflected in the balance sheet). However, these reports cannot give a true view of the financial operations of a company and its financial position in the wake of inflation unless the effects of inflation are reflected in financial statements. Users of financial statements may not make good decisions relating to investment and lending if the financial information provided by the financial reports does not take account of inflation.

Developed countries, including the United Kingdom, United States, Australia and Canada, have begun serious discussions on ways of disclosing the effects of inflation in the financial statements. Accountants in developing countries are, however, lagging behind in voicing or expressing their views on this controversial area of accounting, even though the developing countries are the worst hit of all countries by inflation. Uganda, for example, has experienced an over 500% rise in prices of some of its commodities in the last five years. Britain, on the other hand, experienced an average rate of inflation of 15% in the last five years, recording its highest rate of inflation at about 27% in 1975.

1.2 Interpretation of Inflation

Inflation is expressed differently by different people. Some talk of price-level changes. Some talk of inflation and deflation. Others speak of the rising and falling of prices. All that they mean is an increase or decrease in prices of goods

and services. In the context of the phenomenon of changing prices, inflation is used to describe a situation where the movement in the average purchasing power of money is declining. In other words, the general price level is upward. The use of the term 'inflation' in this thesis does not in any way imply absence of deflation. Both inflation and deflation are kept in mind. Inflation is used because the general trend of prices has been inflationary since 1945.

It should be noted that changes that are a result of shifts in supply and demand for particular goods and services do not imply any change in general price level. Chapter 2 of this thesis explains this point more fully. Commenting on price level changes, Sandilands Report stated:

"The average price movements in practice are only meaningful in respect of specific situations. Inflation does not exist in quantifiable phenomenon independent of price movements in any specific group of individuals or entities and is not a phenomenon capable of independent and objective measurement affecting all individuals and entities according to the selection of goods and services which they buy....."1

1.3 Inflation accounting or 'accounting for price-level changes' is a means of reflecting the effects of price changes in the financial statements. Inflation accounting incorporates inflationary

effects in financial statements. It shows the extent to which inflation has affected the accounting values of assets, liabilities, revenues and expenses. It is aimed at avoiding a mixture of money figures of various purchasing power in the accounts.

Accounting for inflation is aimed at guiding management, shareholders, prospective shareholders, creditors and other users of financial statements in their decision-making. Financial statements conventionally prepared are assumed to satisfy the requirements of the named parties. This can be true only if prices of goods and services have remained stable throughout the periods covered by the financial statements. In reality, however, prices are never stable. Inflationary trends have been experienced in the last 30 years. Kenya in particular has experienced remarkable inflation since 1972[2]. As a result, the financial statements prepared on the basis of a historical-cost system no longer supply sufficient and relevant information to the users of the financial statements. Additional information about the effects of inflation on accounts is required to make financial statements more meaningful.

One of the problems facing the accounting profession is that of determining the best approach to inflation accounting. It is extremely unlikely that a "perfect" solution exists. There is no general consensus on which of the proposed methods is best. Historical-cost accounting is the conventional accounting system which uses historic cost measurements in most situations. 'Conventional accounting' and historical-cost accounting are used synonymously in this thesis.

There are two feasible alternatives to historical-cost accounting. One is the use of a general price index in adjusting the historical costs and is termed 'price-level accounting'. The other is the 'current-value accounting' (or replacement-value accounting). Both price-level accounting and current-value accounting have been proposed to avoid the short-comings of historical-cost accounting. Price-level accounting, which is based on historical-cost accounting, is essentially an extension of the latter. Therefore, it does not overcome all of the inadequacies of historical cost statements, such as the irrelevancy of the historical cost data to current decisions, and the dependability of the historical-cost accounting on outmoded generally accepted accounting principles, which are currently being criticized. Current-value accounting applies current value to items in the financial statements, and this system is not therefore based on historical-cost accounting.

Because it does not show the effects of price changes in financial statements, conventional historical accounting tends to be less meaningful. The information provided in these conventional accounts is misleading. The balance sheet supplies stale information with diminished relevance to the present time; "the information is too old to help."[3]

The income statement presents cumulative results of different periods of accounting years up to the present, which, although helpful, would be improved by being related to the current period. Historical cost is not relevant to decision making unless it enables the decision maker to predict the future trend of events.

In periods of price-level changes, historical cost must be adapted to be relevant. Billy E. Goetz says, "At least relevant data are useless, at worst irrelevant data can lead to serious error."[4]

Inflation accounting is not an easy task, particularly if applied in large manufacturing firms. It requires extra qualified accountants and professional valuers to do the job effectively. The problems involved in accounting for inflation tend to hinder rapid adoption and application of inflation accounting.

It is not my intention to describe how inflation is caused, but to look at the ways by which the effects of inflation can be properly reflected in the financial statements.

1.4 Introductory summary of Historical Developments

Much literature has been written on inflation accounting. Accounting bodies, mainly in U.K.; U.S.; Canada and in Australia, have advocated both the price-level accounting and current-value accounting methods as means of improving accounting information. But the problem which has not been resolved is that there is no general concensus on any one approach to inflation accounting. Some accounting bodies and some individual accountants prefer price-level accounting to current-value accounting. Others have an opposite view. There are still others who argue that historical cost accounting is satisfactory and that there is no need for an alternative basis.

In U.S., the American Institute of Certified Public Accountants (A.I.C.P.A.) sponsored Accounting Research Study No.6 (hereafter referred to as 'ARS No. 6') in 1961 to study how to

report the financial effects of price-level changes as the means of disclosure of the effects on all elements of financial statements. The study was published in 1963 by the A.I.C.P.A. under the title "Reporting the Financial Effects of Price level Changes". The recommendations of ARS No. 6 encouraged increased research into the problem of inflation accounting.

In 1969, the Accounting Principles Board (APB) of the A.I.C.P.A. produced Statement No. 3. entitled "Financial Statements Restated for General Level Changes".[5] APB statement No. 3, along with ARS No. 6, recommended the adoption of a restatement of historical-cost Statements of U.S. companies by the general purchasing power method. The detailed recommendations are given in Chapter Three of this thesis.

In December 1974, the Financial Accounting Standards Board (F.A.S.B.) issued an Exposure Draft entitled "Financial Reporting in the Units of Purchasing Power", proposing essentially the same methods as the A.R.S. No. 6 and APB statement No. 3.

In the United Kingdom, discussions on inflation accounting have been taking place for the last 30 years.[6] However, remarkable attention has been attracted only since 1967 when the rates of inflation began to increase significantly in the U.K. In 1968 the Research Foundation of the Institute of Chartered Accountants in England and Wales published a paper entitled "Accounting for Stewardship in a Period of Inflation." This paper discussed the impact of inflation on companies and described in some detail the practical procedures required to adjust accounts for changes in the purchasing power of money. This approach is similar to that

of F.A.S.B., ARS No. 6 and APB statement No. 3.

On 14th May, 1974, the Accounting Standards Steering Committee (A.S.S.C.)[7] of the U.K. published a provisional Statement of Standard Accounting Practice No. 7 (S.S.A.P.7) based on Exposure Draft No. 8 (ED 8) entitled "Accounting for Changes in the Purchasing Power of Money" which had been issued for comment on 17th January, 1973. Both ED 8 and S.S.A.P.7 recommended the use of the current-purchasing-power (C.P.P.) method of accounting for inflation, which is similar to those recommended by F.A.S.B., ARS No. 6 and APB Statement No. 3.

In response to S.S.A.P.7, the Sandilands Committee issued a Report on Inflation Accounting. The Report recommended Current Value accounting and it was published on 25th June 1975. On 6th January 1976, an "Inflation Accounting Steering Group", under the Chairmanship of D.S. Morpeth, was set up to work on the implementation procedure of the Sandilands Report. In November 1976, the Morpeth Committee issued Exposure Draft No. 18 (ED 18) entitled "Current Cost Accounting" and the exposure period for comments was to expire on May 31st, 1977. The details of ED 18 are nearly the same as those recommended by the Sandilands Report.

Canadian bodies have made attempts to adopt alternatives to historical-cost accounting. Among the active bodies is the Accounting Research Committee (ARC) of Canadian Institute of Chartered Accountants (C.I.C.A.). In July 1975, the committee issued an exposure draft entitled "Accounting for Changes in the General

Purchasing Power of Money". Although this proposal does not go as far as the recommendations of rule-making bodies in some other countries, it could, if approved, result in a recommendation that general-price-level-restated financial information be published in conjunction with conventional historical cost data in Canada for fiscal periods beginning on or after January 1 1977.[8] In August 1976, the CICA's ARC issued a discussion paper on Current Value Accounting (CVA). The discussion paper calls for comments from academicians and practitioners by June 30th, 1977. Australia has also made tremendous steps in discussing and recommending methods of inflation accounting. Her approach tends to be very similar to the U.K. approach on current value accounting. In June 1975, Australian Accountants produced their exposure draft on current value accounting. It was a world-first draft from a professional body, a suggested "how to do it" booklet.[9] In May 1975, the Mathews Committee had been set up in Australia which produced a report on "Inflation and Taxation", specifically directed to the effects of inflation. The report stated: "When the rate of inflation passes a critical level its effects on the taxation system change in kind as well as degree and it becomes difficult for the economic system to adapt in conventional ways. The threshold of adaptation has now been passed and substantial changes need to be made on the basis of both personal and business taxation".[9] In October 1976, the National Council of the Institute of Chartered Accountants in Australia and the General Council of the Australian Society of Accountants issued a statement of Provisional Accounting Standards on "Current Cost Accounting", which is similar to ED 18 of the U.K.

In Kenya, the indigenous companies have not attempted what might correctly be termed "Inflation Accounting". Some firms do, however, make some periodic revaluations to their fixed assets. Many of the foreign subsidiaries located in Kenya also make such periodic revaluations. Some of these subsidiaries, including Dunlop Kenya Limited and Philips Kenya Limited, are actually preparing inflation accounts. In general, however, most of the local companies supply insufficient information relating to the effects of price changes. A detailed report on the financial reporting by these companies is presented in Chapter Four of this thesis. At the end of each chapter of this thesis there is a list of references relating to the subject matter discussed in it.

1.5 Definitions

The following defined terms are included in the thesis:

i). Current Cost, in relation to an asset, means its cost measured by reference to the lowest cost at which the service potential of that asset, when acquired, could currently be obtained by the entity in the normal course of business.

ii). Current Value, in relation to an asset, means value to an entity measured in reference to its 'value' rather than 'cost'.

iii). Historical cost, the original cost of an asset at the time of an arm's-length exchange.

iv). Net Realizable Value, in relation to an asset, means the highest amount that could be obtained from selling the asset, after deducting all expenses of sale.

v). Replacement Value, in relation to an asset, means its value based on replacement cost, after adjustment for the expired period service potential of the asset.

vi) Shareholder's Equity, should be read to include Owners' Equity in relation to business entities which are not incorporated.

vii) Use Value, in relation to an asset, is the discounted future benefits of retaining an asset. This is the economic value of an asset.

viii) Present Value, is synonymous to economic value of an asset.

ix) Monetary items, means assets and liabilities, the amounts of which are fixed by contract or Statute in terms of numbers of shillings regardless of any changes in prices,and includes share capital of any class not participating beyond par value in a distribution of surplus assets in the event of liquidation.

xi). Replacement Cost,in relation to an asset,is the current purchase price of an asset to replace the operating capability of the existing asset;it is the maximum loss on deprival of an asset suffered by a firm.

xii). Useful Life, in relation to depreciable asset,means;-

(a) the estimated period over which the asset is expected to be used,or the period in which the benefits represented by the asset are expected to be derived in the business entity;or alternatively

(b) the estimated total service,expressed in terms of units of production or service,that is expected to be obtained from the asset whilst employed in the business entity.

xiii). Operating Capability, means the ability of the entity, at a given time, to provide goods and/or services in accordance with its then existing resources.

1.6 Abbreviations

The following abbreviations occasionally appear in the thesis.

HC - Historic Cost

GPP - General Purchasing Power (a U.S. term).

CPP - Current Purchasing Power (U.K. term).

GPLA - General Price Level Accounting.

CVA - Current-Value Accounting.

CCA - Current-Cost Accounting.

UV - Use Value.

PV - Present Value.

NRV - Net Realizable Value.

RCA - Replacement-Cost Accounting.

SSAP7 - Statement of Standard Accounting Practice No. 7.

SSAP 18 - Statement of Standard Accounting Practice No. 18.

ARS No. 16 - Accounting Research Study No. 6

APB Statement No. 3 - Accounting Principles Board Statement No. 3.

ASC - Accounting Standards Committee (formerly known as 'Accounting Standards Steering Committee (ASSC)')

A.I.C.P.A - Accounting Institute of Certified Public Accountants.

G.A.A.P. - Generally Accepted Accounting Principles.

F.I.F.O. - First in - First - out (
(Inventory Valuation Methods
L.I.F.O. - Last - in First - out (

F.A.S.B. - Financial Accounting Standards Board.

ASC - Australian Standards Committee (formerly called "Australian Accounting Standards Committee (AASC)).

A.A.A.- American Accounting Association

References

1.) A Report on 'Inflation Accounting' by the Inflation Accounting Committee' (H.M.S.O.; C and. 6225, September 1975) p. 13. The Committee was led by Mr. F.E.P. Sandilands, hence the use of the term 'Sandilands Report'.

2.) Taking August 1971 as base year (Consumer price Index = 100), Nairobi Middle Income Index increased from 85.0 to 159 between 1965 and 1975-an increase of 87.8%. However, the increase in price index between 1965 and 1971 was only 20% while the increase in the index between 1972 and 1975 was 52%. See also the tables for the consumer price indices for the period between August 1971 and December 1976, in chapter three of this thesis (i.e. Tables 3-1 and 3-2 of the Appendix to Chapter Three).

3.) P. Rosenfield, "GPP Accounting: Relevance and Interpretability" Journal of Accountancy, August 1975 pp. 54 - 55.

4.) Goetz Billy E, "Transfer Prices: An Exercise in Relevance and Congruency" Accounting Review, July 1967 p. 435.

5.) Accounting Principles Board of A.I.C.P.A., December 1, 1971 Vol. 1 pp. 701 - 768.

6.) Sandilands Report op. cit. p. 106.

7.) Accounting Standards Steering Committee (A.S.S.C.) was originally established as a committee of the council of the Institute of Chartered Accountants in England and Wales in January 1970. This body was renamed 'Accounting Steering Committee (A.S.C.) in February, 1976. Its aim is to establish a machinery for the development of Accounting Standards.

8.) S. Basu and J.R. Hanna, "Accounting for Changes in the General Purchasing Power of Money: the Impact on Financial Statements of Canadian Corporations for periods 1967 - 1974" Cost and Management Magazine, January - February 1976, p. 4.

9.) Rex Thiele, "Accounting for the Effects of Inflation" The Australian Accountant May 1976, p. 201.

CHAPTER TWO

PURPOSE OF ACCOUNTS AND THE CHARACTERISTICS OF HISTORICAL-COST ACCOUNTING

2.1 Objectives of Financial Statements

Before we look at the inadequacies of historical-cost accounting discussed in the next section, let us review briefly the objectives of financial statements. A discussion of the weaknesses of historical cost accounts will be more understandable if we first learn the objectives of preparing the financial statements.

It is the essence of financial statements to communicate financial information concerning individual business enterprises to users of this information so that they can make intelligent economic decisions. The common vehicles of this information are:-

(1) the income statement whose purpose is to summarize the results of operations of a business enterprise during the whole of a given current accounting period.

(2) the balance sheet which shows the value and nature of the economic resources of the enterprise at a given point in time, and the related interests of creditors and equity of owners in those resources.

Some companies prepare a statement of sources and application of funds in addition to the above two financial statements. Management requires a cash flow statement in addition to the above statements. This statement reflects a forecast of future cashflows.

Financial information is the focal point of public interest

concerning business. Investors, trade creditors, employees, customers, financial analysts, bankers, debenture holders, and other parties are interested in an enterprise's financial information when making their varied economic decisions. A brief look at each party's information requirement can illustrate the purpose of financial statements.

(a) The Trade Creditors are principally concerned with security for the payment of their claims and wish to be assured that a company is solvent and likely to continue in business, and also that it has adequate cash resources to pay its debts promptly as they fall due. The required information can be provided partly by the financial statements, but these creditors can in addition rely on their own estimates of the company's credit-worthiness, very often based on past experience.

(b) Customers would like to ascertain the future continuity of supply of their wants by vendors. These customers use financial information to predict the future supply of their wants by vendors. Alternatively, vendors sometimes rely on customers' financial information in determining the terms of payment for their goods.

(c) Employees require the financial information when formulating and arguing their demands for higher wages better working conditions, more fringe benefits, and for educational facilities for their children. The higher and more persistent that net annual profits are, the stronger the trade Unions' position in demanding higher wages and non-monetary benefits.

(d) Bankers are more concerned about early liquidation of an overdraft by regular cashflows than they are about formal security, unless the company's position becomes desperate.[1] They always demand full managerial accounts and cashflow projections.[1] They use the annual accounts to ensure some security for their money in a general way.

(e) Debenture holders This group includes long-term and medium-term lenders. They rely much more upon accounts information for assurances that their security is not in jeopardy.[1] They analyse the stability of earnings of a company in the past and project it to the future, using the debt ratio and such other measures to determine the maximum amount of money they should be ready to lend.

(f) Investors include the present shareholders and the potential shareholders. The shareholders use the financial information in evaluating their return on the assumption of equity risk. The equity shareholders' wealth is a function of the efficiency, acumen and foresight of the company's senior management.

(g) Tax Authorities assess the corporate tax liability on the basis of the financial information provided by the company's financial statements.

(h) Financial Analysts use the financial information to analyse the strength and weaknesses of an enterprise.

(i) Management requires frequent financial reports to make decisions such as buy-lease, hold-sell, and retain-replace decisions. Such decisions require current prices of the items involved.

The above mentioned parties are among the users of accounting information. Their financial information requirements give a good indication of the information - providing objectives of financial statements. Financial statements should be regarded primarily as serving as a basis for decisions relating to the future. These statements should, therefore, communicate information concerning the past and the present in a manner that provides maximum assistance to the user in assessing the future.

To satisfy the various interests of the users of financial statements, the financial information provided by the statements should be useful. The consideration of usefulness is necessarily subjective and will change, for example, with the composition of the users of accounts. Secondly, the financial information should be fair to various users of accounts with conflicting interests, such as employees versus shareholders, vendors versus customers. Fairness will require changes in financial reporting as changes occur in the interests of society in business. Thirdly, financial statements should be understandable to those who may use them. This requirement raises some difficult questions: 'Should financial statements be understandable by presenting as little information as possible? Or should financial statements present as much necessary financial information as possible?' The two questions seem to ask the same thing but they differ in degree. The first question implies preparing information as sketchily as possible so that it can be comprehended by a layman. This means that the necessary details are avoided because they may confuse the users of accounts. What then is the reasonable amount of information to

be reported in accounts? The author would be in favour of detailed accounts as long as the information reported is material.

Current-value information concerning economic resources provides the investor with meaningful values. In fact the usefulness of financial statements will be increased, as we shall see later, if accountants are willing to acknowledge that measurement, accumulation and summarization of the vast array of economic data on business is a highly subjective process. Objectivity per se hinders the reporting of fairly subjective but relevant information.

In summary, the overall objective of financial statements is to communicate information about the economic resources of a business enterprise and changes in those economic resources. The information will be of lesser use if it is not updated to suit a dynamic environment.

2.2 Characteristics of Historical-Cost Accounting.

2.2.1 Evaluation of the Underlying Assumptions

An understanding of the real nature of the existing inadequacies in financial reporting is essential if there is to be hope of reaching agreement on the objectives of financial statements. Lee states that "the general principles of historical-cost accounting were worked out mainly in the 19th century when price levels changed only slowly, and not always in the same direction. Its vigorous application began in 1930s when, also, the price level was relatively stable in developed countries.

The distortions through ignoring price changes over the economic lives of most assets except land were not large, and were not considered sufficient reason for departing from asset values established by acts of exchange between the entity and outside world...."[1] This picture, however, changed after 1945 when prices rose steadily year after year. Historical-cost accounting is based on rather unrealistic assumptions. The system assumes that:*

1. Prices do not change over time;
2. the original cost of capital is always an appropriate monetary equivalent;
3. accumulated depreciation measures correctly the expired portion of fixed assets;
4. all historical costs are objective, that is, no subjective elements enter in the determination of asset values, in determining the amount of depreciation, and the like; and that information provided by the system is best for decision making.

The above are among the many misleading assumptions inherent in a conventional accounting system. The assumptions do not, however, hold in the present dynamic economic environment. Prices have been rising in the last 30 years. Markets are hardly perfect. Fixed assets, particularly those which last for over five years, are usually undervalued. Depreciation based on these values is undercalculated; the accumulated depreciation does not reflect the correct expired portion of an asset; the profits against which the cost of sales (including depreciation) is charged are overstated.

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* These assumptions are integrated from arguments cited by various writers and committees including P. Rosenfield and Sandilands Committee, both referred to in Chapter One.

This leads to artificially high earnings and excess taxes.

Historical-cost accounting is built on basic principles and conventions which have been accepted for many years. The Sandilands Report reveals that historical-cost accounting 'has been in use at least since the beginning of modern accounting in Renaissance times, and its present characteristics were largely developed in the 19th century to meet the requirements of the limited company![2] The system was developed to safeguard the interests of creditors whose risks were increased by the concept of limited liability. The characteristics of historical-cost accounting were developed against this background.

Historical-cost accounting is based on Generally Accepted Accounting Principles (GAAP). Calculation of profit according to GAAP involves using acquisition cost (the amount that changed hands in the original transaction = historic cost) to value assets and liabilities.

The defendants of historical-cost accounting argue that it is widely understood and is, therefore, more useful to decision makers than a more refined measurement that they may not comprehend. While managers think they understand GAAP profits, they find it hard to make intuitive adjustments for a varying rate of inflation.[3] If the above assumptions were true, then there would be no need to consider maintaining capital in terms of general purchasing power. Nor would there arise the choice between maintaining purchasing power and maintaining service potential. If there were a perfect market, knowing the cost of assets held

would tell us how much it would cost to replace them and how much we could exchange them for in the market. However, with changing prices in practice, it would not be of much benefit to the investor if we tell him what the capital assets of a company cost. This tells him little of the value about the company's current financial position. It does not tell him what the exchange value of the capital is, and thus gives no correct information as to the company's capacity to enter the market and embark on any other project. Neither does it tell him what funds must be employed now in order to set up a business similar to the first started some time in the past. It statistically invalidates many of the calculations and conclusions that might be made on the basis of such information.[4]

2.2.2 The Basics of GAAP

The Generally Accepted Accounting Principles (GAAP) upon which the historical cost basis is built consists of a number of accounting conventions, doctrines and rules.[5]

Conventions are generally agreed upon but are not themselves tested. The resultant validity of the theoretical conclusions rests in a quite fundamental way on validity, that is the usefulness and realism, of the conventions. Sometimes it is suggested that the conventions of historical record accounting do actually form the base upon which everything else is constructed.

The Doctrines exist within the boundaries implied by the conventions and assist accountants when they are attempting to

apply the principles and rules of accounting. In reality though, it is basically the doctrines and rules themselves which form the part of GAAP that really guide the accounting practioner.

The Principles are the broad theoretical guidelines from which deductions are supposedly made to the rules - the procedures and techniques of accounting. Supposedly, each rule can be traced directly, or otherwise, to the principles.

Basically, it is the conventions and principles which tell us why we should use GAAP; the doctrines and rules show us how to use GAAP. Thus, if the conventions lack realism, the adequacy of the whole structure is in doubt. An example of an accounting convention is the concept of 'Going Concern' or 'Continuity' that is, the premise that 'the business entity will continue operations into the unforeseeable future'. Another convention relates to 'monetary valuation', that is, that 'it is necessary and possible to express economic events in terms of a common measuring, example, the shilling'. Note that not all useful information can be expressed in monetary terms; but nothing else is in fact shown in the accounts. Further, what is not in the accounts is likely to be ignored.

An example of doctrines of accounting is conservatism. The best known rule of conservatism' is the 'lower of cost or market' rule for the valuation of inventory. Under this rule, if the historical cost of inventory is below the market value (that is, current replacement cost or net realizable value), we would take the lower figure for inventory valuation purposes. The use of an excessively rapid depreciation method and the overstatement of

taxation provisions would be other common example of practises justified by the doctrine of conservatism. This doctrine creates 'internal inconsistency' in the following manner: the excessive depreciation charges in early years understates assets and profits initially; after a number of years, these assets are completely written off. By then, depreciation on these assets is minimal if not nil. This results in an overstatement of profits in later years.

Another doctrine of accounting is 'consistency'. It stipulates that a method of accounting already in use should be continued in use. For example, if a firm uses Lifo for valuation of its stock, this method should be used continuously in future to facilitate easy comparisons between different periods. If the company changes from Lifo to Fifo, the effect of the change (on profits and value of stock) should be disclosed in notes to financial statements. Other doctrines include 'verifiable objective evidence', 'full disclosure' and 'materiality'.

Accounting Principles include the matching principle. For example, this principle requires that expenses should be matched with the revenues for which those expenses were incurred. Other principles are the 'revenue'and 'expense' recognition (or realization). Revenue recognition is one of the key features of GAAP. Realization in traditional theory essentially means that the revenue recognition point is restricted to the time of the sale of the goods.

Expense recognition is supposed to occur when we can reasonably associate expenses incurred with revenues realized.

The above discussion gives a brief summary of the basics or the foundations of GAAP upon which historical-cost accounting is built.

Historical-cost accounting is defended by its supporters on the grounds that:-

(a) it is simple and understandable,

(b) it is objective,

(c) it has been used for many years and has been improved by being critized, this latter point implying that the system is the best available for decision making,

(d) it is less costly to prepare.

These arguments cannot, however, justify the usefulness of historical-cost accounting in the present years of high inflation. As was stated in the early part of this section, the assumptions made by the system do not hold true now. These assumptions might perhaps have applied in those old days (before 1945) when prices were relatively stable, and in those days of different environmental conditions from those we are currently experiencing. Actually the system is not understandable to most managers. They cannot easily interpret a 'pooled' historical amount which is made up of different money units of purchasing power. The resultant measured amount of long-term fixed assets gives a wrong reflection of the current value of the concerned assets at a balance sheet date. Nor is the historical accounting system 'simple'. Its supporters call it simple because of its dubious assumptions. If, however, all assumptions were removed, such as that of assuming that unit value of money does not change over time, the historical accounting system would not be simple.

Let us turn to some illustrative examples of the weaknesses of historical-cost Accounting.

2.2.3 Illustrative Examples of the Harmful Effects of Historical Cost Accounting

The following examples demonstrate the misleading data produced by conventional statements during inflation, and they show that meaningful information can be produced only if the conventional accounts are modified.

Example I: A taxi was purchased for Shs. 30,000 and it had a life of 5 years. The results of each year were:-

Revenues	Shs. 50,000
Less: Cash expenses (including wages) ..	40,000
Cash margin	10,000
Less: Depreciation (on straight line basis)	6,000
Net profit	4,000

If none of these profits are distributed, the conventional balance sheet at the end of the 5 years would be:-

Capital	30,000	Cash	50,000
Undistributed profits	20,000		
	50,000		50,000

Suppose that all prices have been rising over the five years and it now takes Shs. 50,000 to purchase an identical taxi (assuming no technical changes). Are there really any profits? If we tell a layman (non expert) that we commenced operations with

a new taxi, and no cash, and that five years later we are now in an identical position, he would say that we have broken even.[6]

Example 2: In this case we commenced a business with capital of Shs. 30,000 with which we purchased 5000 inventory items for Shs, 6 each. Trading for the first period was (in conventional accounting):

Revenue (5,000 units @ Shs. 8)	Shs. 40,000
Less: Cost of sales (5,000 units @ Shs. 6)	30,000
Gross Profit	10,000
Less: Expenses (all in cash)	5,000
Net profit	5,000

However, during the period, all prices rose by 10% and the 5000 items replaced on the shelves cost Shs. 33,000. The balance sheet at the end of the period is then:-

Capital	30,000	Cash	2,000
Undistributed profits	5,000	Inventory (5000 units @ 6/50).. ..	33,000
	35,000		35,000

It is clearly seen that we are better off by Shs. 2,000 (cash) and not by the Shs. 5000 shown in the balance sheet as undistributed profits.

Example 3: Three identical lots of land (side by side) were purchased at intervals in a developing suburb for Shs. 10,000, Shs. 20,000 and Shs. 30,000, and they are now worth at least Shs. 40,000 each. They are presently rented to a second hand car - merchant for a total of Shs. 6,000 per annum (net). This

gives a before-tax return of 10% on the conventional total book value of Shs. 60,000. This might give rise to some complacency when reported to the owners by their public accountant; but the real return is only 5% (that is, Shs. 6,000 on Shs. 120,000) and this is the relevant information that should be supplied.

The situation worsens when we consider a depreciable asset. Not only is the denominator understated in the percentage return calculation but the numerator (profit) is overstated because depreciation is calculated conventionally on low, out-of-date cost figures. These two mis-statements of figures combine to produce large, incorrect return percentages.

Example 4: Let us suppose that a sum of Shs. 100,000 is obtained to erect a building and that this money is invested in 8% debentures for a year while some problems concerning the site and a building permit are overcome. Whether prices rise or fall or remain constant during the year, conventional accounting will show a profit of Shs. 8,000 for the interest received. If all prices rise by 20% during the year (and assuming we can still sell the debentures for Shs. 100,000) many would argue that the loss of 20,000 which was incurred through holding the capital in a monetary form while the prices rose by 20% contributes to an overall net loss of Shs. 12,000 (that is, Shs. 20,000 less the interest of Shs. 8,000) and that to show a profit of Shs. 8,000 is misleading.

Example 5: A machine is purchased for Shs. 6,000 in year 1 and is estimated to have useful life of 6 years. After 3 years, the accumulated depreciation is Shs. 3,000 and the book value of the machine is Shs. 3,000. But in year 3, an identical machine in the

market, one-half depreciated is valued at Shs. 5,000. This shows that the book value of the machine is understated by Shs. 2,000 and that depreciation is being undercharged. This leads to overstatement of profits and hence an exaggerated measured rate of return on investments.

Here then is a summary of the harmful features of internal and external reports and statements based on conventional measurement of data:[6]

The prepared reports and statements:

(1) overstate profits because depreciation is understated during inflation, costs of goods sold are also understated, and losses incurred on holding monetary assets during inflation are ignored;

(2) undervalue most assets;

(3) result thus in overstatement of rate of return on capital;

(4) contain incorrect product costs, and hence result in incorrect selling price determinations, wrong decision-making on sale contracts, etc;

(5) result in incorrect evaluations of management and divisional performances (at various levels);

(6) can produce incorrect dividend and profit retention decisions;

(7) often result in incorrect capital expenditure, replacement, make-or-buy etc. decisions being made because of the inclusion of out-of-date, stale cost data in the economic analysis performed;

(8) results in higher taxes because of inflated profits (following from number 1 above);

(9) do not show the effects of price changes (inflation) in the accounts.

The following sub-optimum conditions are experienced when using traditional historical cost accounting:-

(a) Many duty (tariff) decisions and government price-fixing determinations have been based on incorrect, non-current costs over the years. It is possible that the effects on many industries have been tremendous.

(b) National income statistics are often most inaccurate because they are, to a large extent, a summation of accounting results of thousands of firms and companies, nearly all of which are incorrect in varying degrees because of (1) and (2) above. This is a serious matter because national income data forms the basis for many decisions by governments, large companies, etc.

(c) Equitable taxation, as among companies on the one hand, and as between companies and private individuals on the other, cannot be possible until the base allows for deductions for all expenses in current prices and for losses incurred through holding monetary items (when prices rise).

(d) Capital investments are often channeled into various industries by decisions based largely on accounting reports. The optimum allocation of resources in our society cannot occur, therefore, when profit return on capital, cost figures, etc. continue to be produced and reported in incorrect ways.

The above named flaws of historical-cost accounting indicate clearly that both published and unpublished financial statements of corporate enterprises do not effectively reflect the economic reality in regard to resources, obligations, transactions, and other events in the real world of corporate business.[7] In addition the balance sheet based on historical-cost accounting becomes more and more meaningless as mixed shilling balances are accumulated.

2.2.4 Demand for Alternatives to Historical-Cost Accounting.

Because of the weaknesses of the conventional accounting system based on measuring historical costs, it has been recommended by some people that historical-cost accounting should be replaced by a better alternative system. The recommended systems are 'price-level accounting' and the 'current-value accounting'. Mr. Robin Waldron has written:

"..... Let us save our clients from the effects of inflation so far as we can, by giving them the proper information, by giving them accounts showing the cashflow information, by giving them accounts showing the impact of inflation on the true earnings in terms of purchasing power and the needed retentions for the replacement of fixed assets needed to earn revenue."[8] Mr. Waldron indicated correctly that for the financial information to be satisfactory, a funds flow statement should be prepared in addition to the income statement and balance sheet, both adjusted for inflation. Cash flow projections should always be prepared for internal use by management. The Council of the Institute of

Chartered Accountants in England and Wales published Recommendation XV on accounting for price-level changes in 1952, which stated:

"..... it would be a major development in the building up of a coherent and logical structure of accounting principles if the limitations on accounts based on historical cost could be eliminated or reduced by an adoption of new principles".[9] This statement affirms the most telling objection to historical-cost accounting, namely, that the system lacks coherence. Mr. Lee asserts that "historical-cost accounting is not a system at all, but a compendium of practices slowly evolved by accountants over the past 6-7 centuries, and clearly formulated only within the last fifty years....."[10]. The Council of the Institute of chartered Accountants in England and Wales, in their recommendation XV, concluded that "the alternatives to historical-cost which have so far been suggested appear to have serious defects and their logical application would raise social and economic issues going far beyond the realm of accountancy. The Council is therefore unable to regard any of the suggestions so far made as being acceptable to existing principles based on historical cost".[9] This Council's conclusion seems to have been short-sighted and based on little knowledge about the advantages of the alternative systems. This conclusion could perhaps be justified in that period (1952) when the distortions of inflation were not serious. The Council, however, changed its attitude in the late 1960s. Thus, in 1968, the research committee of the Institute of Chartered Accountants in England and Wales published a well-balanced study.

It recommends that accountants should use supplementary calculations, geared to a general index, as an aid to understanding; and that companies should set aside to an 'Inflation Reserve' any amount by which the conventional profit exceeds the profits recalculated in terms of current pounds. Mr. Donald Bevis has also recommended a change in the current conventional accounting system. He states: "Everyone, including the historical cost school, is arguing for a change. If we are to serve the investor, expecially considering the effects of inflation, technological changes, changes in social philosophies, and changes in consumer desires, I do not think we can imagine we can ignore this need for change.....".[11] On 25th, September, 1975, Mr. W.P.E. Mang, Executive Vice-President of Russelsteel Ltd., Montreal, in a panel said: "I really do not think that management fully appreciates the potentially ruinous business consequences which are lurking just around the corner in the inflationary situation".[12] The reason for this comment is that management is not aware of the real, cold, hard facts about the effects of inflation on the continuity of a business.

It is clear that all decision making rests on information about the future and not about the past. Historical data is past data and cannot help in predicting the future with reasonable accuracy. Consequently, as most accounting is based on either current or past measurements, it will normally be necessary to use this information only as a basis for estimates of future trends. We cannot afford to continue keeping users of financial statements ignorant of the true facts of business financial position (reflected in balance sheet) and its operating efficiency

(reflected in the income statement). We require a fair system of accounting. We require financial data which can help us to appraise with accuracy the efficiency of management performance, the solvency of a company, the competitive ability of a company, and the relevance of management decisions. Each company strives for survival, but no company can continue to survive unless it ensures retention of sufficient funds for replacement of assets and for expansion. Historical-cost accounting tends to exaggerate profits during inflation, and hence also excess payment of dividends which may result in eroding the invested capital. Current-value accounting, or any other such system, may probably guarantee sufficient rententions of funds. We shall discuss the proposed alternatives in the next chapter.

Before we begin to examine vigorously the qualities of the proposed alternatives to inflation accounting, let us have a look at the distinction between:-

(a) relative price changes and,

(b) changes in the value of money.

Relative prices changes relate to changes in prices of specific assets relative to other assets. It is more or less a concern for current values of specific assets. The changes in the value of money is a concern for changes in the general price levels. The distinction is clearly explained below.

2.3 Relative Price Changes Versus Changes in the Value of Money

The pattern of price change is such that we find it difficult to know exactly whether there has been a shift in the relative

value of products or whether there has been a general change in prices and a corresponding change in the value of money. There may be a general increase in prices of say 10% but one may find that some of the prices decreased and some prices remained unchanged. An increase in general price-level by 10% indicates a decrease in the value of purchasing power of money by 10%. If the prices are changed in such a way that increases in some prices were fully offset by decreases in other prices, there would have been no change in the value of money, but the relative value of individual commodities would obviously have changed. A change in price of any particular commodity may, but not necessarily, reflect a change in its real value relative to other goods. The point is that an increase in the price of a particular good may reflect a change in its value relative to all other goods and services in the economy, and not simply a change in the size of the monetary measuring unit (the shilling).[13]

Illustrative Example

Suppose that a company invests Shs. 100 in year 1 to produce a good, X, which is expected to sell for Shs. 150 in year 2. The cost of producing X has risen to Shs. 160 in year 2, and because demand is strong the company is able to sell X for Shs. 200 in year 2. Between year 1 and year 2, prices in general throughout the economy have risen by 10% (that is the value of money has declined by 10%).

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Cumputation of Income

Method 1 Conventional Accounting Income (with shillings).

Revenue realized in year 2	Shs. 200
Actual costs incurred in year 1	100
Monetary income (profit)	Shs. 100

Method 2 Mixed-shillings income with price gain isolated

Revenue realized in year 2	Shs. 200
Replacement cost at date of sale	160
Operating margin	40
Add: Price gain (Replacement cost of Shs. 160 minus cost of Shs. 100).	60
Profit	Shs 100

Method 3 Income Measured in Constant Shillings

Revenue in current (year 2) shillings	Shs. 200
Less: Cost of Production expressed in year 2 purchasing power (Shs. 100 x 110%).. ..	110
Net income measured in shillings of equal value ..	Shs. 90

Method 4 — Combination of Method 2 and 3

Revenue realized in year 2		Shs. 200
Less: Replacement cost at date of sale . ..		160
Operating margin		40
Add: Realized gain:		
Replacement cost at time of sale-Shs. 160		
Less: Cost of sales expressed in year2 purchasing power	110	50
Profit		Shs. 90

The accounting income (or conventional income) in method 1 reflects the entire difference between shillings or revenue and cost without regard to the difference between their relative size. Under method 2, the effect of changes in specific prices is isolated, and the fact that two - thirds of the income is due to a price gain is revealed. Both these methods, however, use money as the unit of measurement. Method 3 uses shillings of constant value. Both revenues and costs are expressed in year 2 shillings. This method 3 shows less profit (Shs. 90) because the firm must recover Shs. 110 year 2 shillings in order to be as well off as it was when it invested Shs. 100 year 1 shillings in X. Method 4 is similar to method 3, but unlike method 3, it isolates changes in specific prices, and the realized gain.

Adjustments of accounting calculations of income for inflation are not intended to eliminate the effects of change in relative prices. Indeed, the latter effects should not be eliminated if income is to be reported correctly, either in

constant prices or in current prices.[14] Changes in the weather, technological changes, pressure of population available and shifts in demand all make for increases in some prices and decreases in others, even when the general price-level may be stable. A policy destined to maintain a constant general price-level must allow for changes in relative prices because productivity in different industries moves at different rates.

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CHAPTER THREE

APPROACHES TO INFLATION ACCOUNTING

Section I: Proposed Methods of Inflation Accounting

3.1 Price-Level Accounting

Price-level accounting is one of the two approaches to inflation accounting which have been advocated. The other approach is current-value accounting. There is, however, considerable confusion as to the purposes of these two techniques. Some people incorrectly believe that the two techniques are alternatives to historical-cost accounting. Although both techniques are considered ways of accounting for inflation, they cannot per se be considered to be alternatives for remedying the defects of historical-cost accounting. Price-level accounting is based on historical-cost accounting - it is a restatement of historical cost accounting statements, which are expressed in varying values, into statements expressed in a single unit of measurement. It is thus essentially an extension of historical cost accounting. Obviously, therefore, it cannot overcome all the inadequacies of historical cost statements. It deals with changes in general price level. It relies on a general price index. Current-value accounting, on the other hand, deals with specific price changes of individual items; it relies on specific price indices or on current market values, whichever are more appropriate.

3.1.1. Features of Price-Level Accounting

Price level accounting is often termed general purchasing power (GPP) accounting in the Americas, or current purchasing power (CPP)

accounting in Europe. It is also termed price-level restatements, or price-level adjustments. The reader should note these terminologies when reading this thesis. Price-level accounting is predominantly used in this thesis.

The broad objectives of price-level accounting can be outlined and analysed from several viewpoints. L. S. Rosen says: "In a simple sense, a price-level restatement of historic cost data merely converts the yardstick used to that of a single basis. In a more technical sense, fluctuations in the exchange value of money are isolated, and then withdrawn from price-level restated income."[1]

Price-level-restated reports contain data expressed in a common denominator, for example, in shillings of the same purchasing power. It deals solely with changes in the overall price level. "It may be considered as a method of accounting in homogeneous units of account of equivalent general purchasing power."[2] It aims at maintaining capital in terms of constant purchasing power. To achieve this objective, it is necessary to restate shareholders' equity, using the appropriate general price index. Capital maintenance in terms of constant purchasing power is the concept implied in price-level accounting. Balance sheets prepared on a traditional historical cost basis are restated in terms of general purchasing power of the shilling at balance sheet date, using a general price index. In the profit and loss statement, this approach results in cost of goods sold and depreciation for the period being based on shillings of current purchasing power. The profit (or loss) for the period includes, as an additional

item, gains (or losses) on any monetary items.

The earliest proposal for price-level accounting in the U.S. was made by Henry W. Sweeney in his book, "Stabilized Accounting" in 1936. He is regarded as the father of this accounting system. His three objections to conventional accounting were:-[3]

(a) It is not suitable for indicating whether an enterprise has approached near the usual goal of economic activity (in terms of increase in general purchasing power of the owner's investment).

(b) It combines figures that are not expressed in the same kind of measuring unit, and thus it violates the basic mathematical axiom that 'like added to like gives like' (an aggregation problem).

(c) It is not complete because it does not include all kinds of realized and unrealized profit and loss from changes in value of money.

Sweeney proposed that the cost-of-living index or, in its absence, the best obtainable general index, be used to adjust historic cost. Sweeney also recommended a revaluation of what he called "real assets" at replacement cost.

In the current inflationary period, restatement of a profit and loss statement will result in the following effects, which will differ from firm to firm:-

(i) When monetary gains are recognized, firms with large amounts of debt outstanding may do much better than is shown in conventional statements.

(ii) Income before monetary gain will be reduced for all

firms. This confirms the often stated view that conventionally reported earnings are inflated during inflation.

(iii) The percentage increase in profit will be relatively low compared to that under conventional accounting.

It is often stated by many companies that profits increased by a certain percentage. If the income statement figure are, however, restated to balance-sheet-date purchasing-power money, the percentage increase will be reduced greatly.---

3.1.2. The Conversion Process

Price - level adjustments involve several steps of conversion. Generally, there are five steps involved in this conversion process:

STEP 1:

Items in the opening balance sheet of the basic accounts are converted into current purchasing power units relating to the beginning of the year by:-

(a) adjusting all amounts representing non-monetary items by the change in the relevant index (examples, Retail Price Index (RPI) in U.K. and Kenya, Gross National Product (GNP) Price Deflator in U.S.) between the time of acquisition or most recent valuation and the beginning of the year, and

(b) Making no adjustment to the amounts representing monetary items because these are already in terms of both current monetary and purchasing power units relating to the beginning of the year.

Step 1 is only necessary during the first year of introduction of price level restatements. In the second and subsequent years, the ending CPP (or GPP) balance sheet of the previous year will be taken as the opening balance sheet of the year of account without further necessary adjustment of it.

STEP 2:

Calculate the loss (or gain) on being a net lender (or borrower). A net lender loses while a net borrower gains during a period of rising prices. The reverse occurs during deflation.

STEP 3:

Write up the stabilized income statement.

STEP 4:

All items (both monetary and non-monetary) in the converted opening balance sheet for the year are adjusted by the change in the relevant index (RPI or GNP - Deflator, etc.) between the beginning and end of the year in order to express the items in the opening balance sheet in terms of current purchasing power units relating to the balance sheet date at the end of the year. The process is termed "updating" or "rolling forward".

STEP 5:

Items in the closing balance sheet of basic accounts are converted into current purchasing power units relating to the end of the year by:-

(a) Adjusting all the amounts representing non-monetary items by the change in the relevant index between the time of acquisition or more recent revaluation and the end of the year; and

(b) Making no adjustment to monetary assets because these are already in terms of both current monetary units and purchasing power units relating to the end of the year.

3.1.3. Merits of Price - Level Accounting

Price - level restatements of historical-cost data potentially can provide useful information for managers as well as for investors, prospective investors, creditors, and other users of financial reports. Such restatements have the following merits:-

1. The computation of general purchasing power gains and losses may prove helpful in formulating policies on methods of financing, on distribution of assets in the company, on credit policy, etc.
2. The segregation of inflation effects from gross profits can be helpful in judging the performance of managers. The price - level adjusted statements exclude the effects of inflation on the results of operations.[4] They reveal gains arising from inflation, what the "true" profits are, and what real growth has taken place. Sales are matched with production costs adjusted to shillings of the same value, and costs include depreciation charges based on the same shilling value.
3. Restatements adjust accounts for changes in shareholders' purchasing power - which to some people is the ultimate accounting (see No. 6 below).
4. Restatements retain the objectivity of historical-cost accounting. The adjusted statements can at least be interpreted and understood as objectively as conventional financial statements.
5. Distortion that accumulates in the measurement of the shareholder's equity in an enterprise is removed with the passage of time. The historical amount of the investment becomes a progressively more meaningless figure as earnings retained in the business from year to year are added to share capital. But when shareholders

equity is restated in terms of current purchasing power, the investment in business is reflected in a more informative way.

6. The restated financial statements conform to the same accounting principles as the historical oriented statements of which they are extensions or refinements.

7. Comparability of various financial statements is increased.

3.1.4. Demerits of Price - Level Accounting

Looking at the above enumeration of the advantages of price level accounting, some people may jump to the conclusion that it is the best method for inflation accounting. Such hasty and unsupported conclusions are unwise. The following are among the demerits of price - level accounting:-

1. It does not provide a solution to all problems caused by historical-cost statements. Being an extension of historical-cost accounting, the price-level adjusted statements retain most of the flaws of traditional accounting. The modifications (or adjustments) of historical costs do not necessarily reflect the current position. The adjusted financial statements are also built on the G.A.A.P. which are under serious criticisms these days.

2. It does not reflect the amount of cash available for replacement of assets. Although such a reflection is not necessary, an accounting system should aim at achieving it.

3. Index Problem. What price index is the most appropriate for adjusting all types of financial statements? Selection of such an index is extremely difficult. The general price index is prepared on the basis of prices of selected groups of

consumer commodities with appropriate weights assigned to each group to reflect their relative importance to the spending of the selected consumers. However, the measurement of changes in the 'average' purchasing power of money for consumer goods as acquired by an assumed 'average' consumer is subject to limitations.[5] This is so because different consumers have different spending patterns and are affected. not so much by changes in consumer prices in general. as they are by changes in the prices of the commodities they actually acquire.

Example The purchasing power of a person's savings accumulated for the purpose of purchasing a house of a particular type and in a particular locality will be affected by changes in the prices of house of the type and locality in question, and these changes may be quite different from changes in the general consumer price index.

Current purchasing power value of the commodities in which the firm deals can change differently from the general level of prices.

In addition to the weighting problem above, there is the problem of choosing the goods averagely consumed by a family. The index is also distorted by:-[6]

(a) changes in tastes to new brands over time,

(b) price control and rationing by government,

(c) subsidies and indirect taxes.

(4) Some critics insist that recording a current "monetary gain" relating to outstanding long-term debt would be

misleading.Price-level accounting regards such a record to be in order. The critics acknowledge the gain from repaying the debt in cheaper shillings,but believe that the gain should not be recognized until it is actually realized by reducing (not simply by refunding) the debt.[7] The issue is important for utilities and other highly leveraged companies because recording the gain currently would increase reported profits during the inflationary period. This result is contrary to the general belief that inrlation - adjusted profits should be lower than those reported under Generally Accepted Accounting Principles.

(5) Using the general price index to adjust the historical cost of plant, in order to calculate a 'better' figure of depreciation expense, would coincidentally result in a figure that approximates the current cost of replacing a plant. This is because not all businesses are affected by general inflationary factors. They are affected by particular increases in their operating costs and plant expenditures. "Therefore, critics contend that general price - level accounting profits reflect neither historical - cost nor replacement value."[8]

The above criticisms of price - level accounting suggest that the system does not provide a permanent solution to the inflation - accounting problem. It is only a partial move to inflation accounting. Many supporters of the system suggest that prepared price - level accounting statements should be supplementary to the traditional accounting statements. It is the author's view that supplementa statements would be more confusing than the existing reporting

system. The laymen users of statements (or non versatile users of statements) may not understand the precise difference between the two reporting systems. This calls for re-education of these statement users, for otherwise they will be suspicious of the work of accountants. They may say accountants are trying to manipulate financial statements for their own benefit.

The view that price - level accounting does not provide a permanent solution was implied in Hutchins' expression that "price-level adjusted financial statements will not solve the defects of historical-cost accounting, but they will help the public appreciate the pitfalls of our historical cost framework, as well as pave the way towards current value accounting. Meanwhile, research must continue on the development of a new accounting framework".[9]

3.2 Current-Value Accounting

Current-value accounting (CVA) or Current-cost Accounting (CCA) is one of the proposed alternative approaches to accounting for inflation. This particular system has aroused hot debates in the past four years. It has received much support from academicians and practitioners. Some governments, led by the United Kingdom (U.K.), have also taken interest in this system. The U.K. set up a committee chaired by F.E.P. Sandilands, to study and recommend on current-value accounting. This led to the publication of the Sandilands Report[10] which is supposed to be implemented by the middle of 1977. We shall consider this report

in greater detail in section II of this chapter.

3.2.1 General Characteristics of Current-Value Accounting.

While price-level accounting recognizes the fluctuating properties of the monetary unit and attempts to restate recorded amounts at a constant unit of value, current-value accounting, on the other hand, recognizes only those price changes that specifically affect the assets employed by a business. Current-value accounting adopts a current value approach to the statement of assets in the balance sheet, and also deals with problems associated with maintenance of the operating capability of the entity. Profit measurement under it is based on the principle of matching revenue and expense both expressed in current values. The aim of CVA is to set aside the sums needed to maintain the physical level of fixed assets and stock.

Current-value accounting covers a wide range of different systems whose common feature is that net assets are measured by reference to their value rather than to their cost. It attempts to present the current value of all resources (assets) and obligations (liabilities)at the balance sheet date. It does not restate historical cost data as price-level accounting does by using a general price index. The current values may be significantly different from the cost amounts shown, either in conventional historical-cost financial statements or in general price-level adjusted cost-based statements.

The term 'value accounting' has no agreed definition. A question normally raised is: Which variation of current value should be employed? If one concept of current value is to be most widely used? The feasible options of current value accounting are:-

(1) Replacement Cost (RC)

(2) Use Value or Present Value (PV)

(3) Net Realizable Value (NRV)

The common characteristics of these options is that each uses money as a unit of measurement. The main difference between them is that each adopts a different basis of asset valuation and a different concept of profit. Replacement - cost accounting comes close to meeting the dominant requirement of users of financial statements;that is, the showing of operating profit and holding gains separately.

The three options show net assets at some valuation figure and not at cost. Because the net assets are measured by reference to their value rather than to their historical cost, the system of value accounting results in unrealized holding gains being shown in the financial statements of a company when the value of the net assets is rising.

It is worth noting the following qualities of value accounting:[11]

(1) There are no comprehensive sets of accounting standards or operating guidelines on value accounting that have been drawn up by the accounting profession.

(2) Value accounting is a 'principle' rather than a system, and is at a different stage of development from historic-cost accounting which has for many years formed the basis of conventional accounting practice.

(3) Information given on the basis of asset valuations is more useful and realistic than information based on costs, particularly during a period of changing prices.

(4) There is no single agreed basis of valuation and the system, therefore, seems to be too subjective to form the basis of accounts which are to be used for many different purposes. This is the main objection of value accounting. The Sandilands Report states: "..... to the extent that each of the various methods of value accounting is founded on a defined basis of valuation, it may be considered less subjective than conventional accounting which permits partial or complete valuations of net assets on a variety of different bases."[12]

(5) Another objection to current-value accounting is that there is only a remote possibility of valuing intangible assets on a regular basis that would be suitable for annual accounts. In practice, a current valuation must be confined to those assets on which the current cost or realizable value can be readily ascertained.[13]

The following are six possible relationships between the three options (or techniques) namely RC, PV, and NRV,[14]

In Case of where	Basis of Valuation of Assets The Correct basis of Valuation is
1. NRV > PV > RC	RC
2. NRV > RC > PV	RC
3. PV > RC > NRV	RC
4. PV > NRV > RC	RC
5. RC > PV > NRV	PV (Asset to be retained)
6. RC > NRV > PV	NRV (Asset to be sold)*

* Although NRV > PV, no intention to sell the asset need be implied on the part of the company.

The relationships above show that RC has more economic meaning to the firm under most circumstances. RC is almost invariably the upper limit to current cost as opposed to NRV, or the economic value of the expected future net cash receipts from the asset.

In case 1 and 2, the firm would be better off by disposing of the asset than by using it, since NRV is higher than PV. However, the maximum loss on deprival suffered by the firm in

these cases in not NRV itself but RC. This is the amount required to purchase another equivalent asset, the maximum loss the firm would suffer if it were suddenly deprived of the existing asset.

In cases 3 and 4, the firm would be better off by using the asset than by disposing of it since PV> NRV. However, as in cases 1 and 2, the maximum loss the firm would suffer if deprived of its asset is RC which is less than PV. In these cases, therefore, the value of the asset to the business is RC - the maximum amount required to restore the asset.

In cases 5 and 6, RC will not be the value of the asset to the business. In these two cases, the firm cannot gain as much, by either using the asset or disposing of it, as it would cost to replace it. If the firm were suddenly deprived of the asset the maximum loss it would suffer must in such circumstances be less than the asset's replacement cost (RC), since in these cases, if the firm were deprived of the asset and were given in exchange enough money to replace it, the firm would be better off than it was before being deprived of the asset. In cases 5 and 6, the maximum loss the firm would suffer on deprival of the asset will be the higher of PV and NRV and these amounts will be the value of the asset to the business in cases 5 and 6 respectively.

It may therefore be stated that the value of an asset to a company is the written down current replacement cost (current purchase price), except in situations where the written down current replacement cost is higher than both the 'economic value' and the net realizable value' of the asset to the company.

Under this circumstance, the value of an asset is the higher of economic value or net realizable value. This can be verified by the table given above (p.53)

Case 5 is the most likely to arise in regard to large specialized assets whose use is highly specific to an industry and where, as a result, NRV may be zero or near zero.

It is important to note the following:-

- The choice of any of the three bases (or techniques) of valuation does not imply any intention on the part of the company (of retaining, selling or replacing an asset).
- RC is the higher limit of valuation.
- NRV is the lower limit unless it is greater than RC.
- RC and NRV (which are market values) are said to be objective - thus possessing a virtue of historical-cost accounting.
- Use value (or economic value - PV) must of course be based on a more subjective estimate by management.
- Management must make the decision on whether to use or sell an asset utilizing measurements provided by each of the three bases (PV, NRV and RC).

A discussion of each of the three techniques follows.

3.2.1. Replacement-Cost Accounting (RCA)

This is the best known form of value accounting. The Current Value Draft prepared by the Australian Accounting

Standards Committee, defines replacement cost as "the lowest amount that would have to be paid, in the normal course of business, to obtain an asset of equivalent operating capability."[15] This can be contrasted with 'replacement value' which is the asset's value based on replacement cost, after adjustment for the already expired service potential of the asset. Replacement cost may alternatively be defined as the cost of replacing the service to which the asset relates.

Basic Concept underlying Replacement-Cost Accounting

A business enterprise attempts to achieve continuity in its operations; and as continuity necessitates replacement of assets, charges for the consumption of assets should be based on the cost of replacing them. It is unfortunate that the concept brings in the idea of some other asset to replace the present asset, but it is argued, particularly by economists, that the replacement cost to be entered in the balance sheet is the cost of maintaining current operating capacity. "This may work in very simple cases but can hardly be realistic in most modern industry."[16] It is very difficult practically to measure the current capacity of a machine and then equate the capacity with the replacing machine.

Three essential Features of Replacement-Cost Accounting[17]

(1) The amounts are presented in terms of monetary units.

This is an advantage of RCA because money is a modern unit of measure of value, and RCA remains in the tradition of historic-cost accounting in being based on money as a unit of account.

(2) Valuation of assets is made by reference to cost of replacing the services provided by the assets. In the case of depreciating assets, valuation is by reference to written-down current cost of assets less the accrued depreciation. Replacement costs are determined by a variety of methods including the use of specific price indices appropriate to the assets possessed by the company. So far as the balance sheet is concerned, no adjustment is required to monetary assets because when the accounts are expressed in monetary units they are constant in 'value'. The holding gains arising from revaluation of assets are taken into balance sheet reserves.

(3) Profit under replacement cost accounting is based on the concept of capital maintenance. No sums are regarded as profit until provision has been made to replace the company's productive assets as they wear out; that is the system aims at maintaining a company's assets at a constant physical level. The depreciation charge is based on the value of fixed assets established at the end of the year concerned.

To repeat, the valuation of an asset on the basis of its current replacement cost or its current NRV does not imply any intention either to replace or sell the asset. It is likely that many supporters of replacement cost accounting assume that the

main purpose of an accounting system based on the valuation of assets by reference to their current replacement cost is to ensure that no sums are classed as profit until sufficient funds have been withheld from profits to replace the company's existing assets when they wear out.

Under replacement-cost accounting as normally practised, stocks* consumed are charged to the profit and loss account at their current replacement cost at the time of sale. Any difference between the appraised value and the historic cost of stock is transferred to 'stock revaluation reserve.' So far as stocks are concerned, the replacement-cost system will lead to the figure of 'operating profit' which we consider is the dominant requirement of users of accounts.

Advantages of Replacement Cost Accounting

(1) It gives the user of accounting data additional and more relevant information about the economic resources of a business and the value in terms of the replacement cost of resources consumed during any period.

(2) It avoids the use of historical cost and thus it removes most of the flaws of historical-cost accounting.

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* Stocks in this case do not include fixed assets. The word 'stock' means 'inventory'

Objections to Replacement-Cost Accounting

(1) In periods of falling prices, the application of replacement cost leads to depreciation provisions and charges to stock consumed which may be less than the original cost of the fixed assets and stock consumed. This is, in my opinion, rather absurd because the accumulated depreciation and total charges to stock consumed are realistically supposed to be at least equal to the historical cost of the fixed assets and stock consumed respectively. Otherwise, it would appear incorrectly that replacement-cost profit is greater than historical-cost profit.

(2) It is argued by some writers that replacement-cost accounting does not distinguish between changes in the value of money and changes in relative prices of specific goods and services, and is, therefore, not a technique of accounting for inflation. Unlike the above view, the Sandilands Committee argued that replacement cost is legitimate to describe replacement-cost accounting as a means of accounting for inflation as it affects individual companies.*

(3) It has been argued that because replacement-cost accounting uses a variety of methods including specific indices in order to estimate the replacement cost of assets, there is less comparability between the results of different

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* See Sandilands Report, pp. 147 - 148

companies in different industries than there would be if a simple general index were used by all companies. The Sandilands Committee (see p. 148 of the report) argues to the contrary by stating that the results of different companies computed on this basis are comparable in terms of current costs and values. The Committee believes that the use of different indices and methods of valuation appropriate to each company is what makes the results more comparable. It is my opinion that the Sandilands Committee is not precisely correct. The correct valuation of various assets depends on the experience of the valuers and the degrees of their biases in making final value judgements. The Committee also assumes that markets are perfect, whereas there is much market imperfection in actual fact. The resultant values of assets of a company will depend on the availability of information of the market for assets, the qualification of the valuers, the specific replacement assets available and the time taken to value those assets. Different valuers may come out with different values of assets of the same company. Such variations may actually hinder good comparisons between different companies. The comparison is, however, more realistic under replacement-cost accounting than under both the traditional historical-cost accounting and under price-level accounting.

(4) It is too subjective and too difficult to apply in modern

industry as compared to historical-cost accounting. Subjectivity arises particularly in valuing items for which similar items are not being traded in the market, with valuations being made on the basis of guesses. Auditors argue that RC is not as objective a measure as is historical cost which can be verified by reference to the records of the transaction. "It is also a less prudent value than historic cost when prices are rising because it brings into accounts gains which are not realized and may never be realized," Bailey argued.[18]

(5) Replacement-cost accounting may overstate the 'value to the business' of certain assets. If current purchase price (replacement cost) were applied to all assets during inflation as a measure of their value, replacement-cost accounting may overstate the value to the business of certain assets whose value is correctly measured by their realizable value or economic value. Depreciation charges based on replacement cost may thus overstate the amount of assets consumed during the year, and would therefore not lead to a fair operating profit in the income statement.

The overstatement of assets consumed may be worsened if 'backlog depreciation' is taken into account. If the replacement cost of an existing asset at the end of its useful life cannot be estimated precisely, the normal depreciation provision based on

end-of-each year asset value may not in fact lead to an accumulated total provision for depreciation equal to the end-of-asset-life replacement cost. To aim at accumulating exactly the required total provision, a firm may add each year (except in the first year) a provision to make up the 'backlog' of underprovision in the previous years. Hence the use of the term 'backlog depreciation'. When current price of an asset is rising, backlog depreciation enables an accumulated total provicion for depreciation equal to the gross (undepreciated) value of the asset at the end of its last year of life. If, however, backlog depreciation is charged against the profit and loss account, the charge for depreciation for the year will exceed the 'value to the business' of the assets consumed during the year. To avoid this, backlog depreciation should be charged against the related revaluation surpluses, rather than to the profit and loss account.

3-2-2 Present Value (PV) or Use Value Accounting

Present value is often termed "economic value". It is believed to be the most subjective and conceptually most difficult of all the three value accounting techniques. It is based on discounting the future cash benefits of assets - especially for individual assets. It is the summation of the present value of expected cash benefits of each individual asset over its useful life.

Features of Present Value Accounting

(1) It is based on the monetary unit as a unit of measurement.

(2) It is based on the principle that assets and liabilities should be shown in the balance sheet at valuation, that is, at their 'economic value' (present value).

(3) It discounts future cashflows arising from the use of assets over the estimated lives of those assets.

Objections to Present Value Accounting

(1) The present value concept assumes that it is possible to determine the future cashflows directly associated with each individual asset. This, however, is not practical for all assets. How do you determine the future benefits accruing to each of the assets which are used jointly? How can you determine future cashflows accruing to a factory plant without taking account of the machinery in it? Such questions cannot easily be answered. To attempt to measure such benefits must of necessity introduce much subjectivity into the measurement.

From the six cases which arise in ranking RC, PV, and NRV, we said that when RC > PV > NRV, the asset is to be valued at PV. However, this is not possible in practice. Following Gee and Peasnell's variant rule,[19] the asset could be valued at NRV, but because of the resultant absurdity from doing so, the asset should be valued at RC. Valuation by use of RC has some disadvantage

also in that it may end up overstating the total value of the firm, but this is less serious than trying to use PV or NRV. NRV is objected to under this case because of two reasons:-

(a) In the case of RC > PV > NRV, assets will frequently be fixed assets with substantial costs of transportation, such as blast furnaces. The NRV of an asset of this type may well be negative, in the sense that it would be necessary to pay people to take it away. Thus valuation at NRV of, say, a blast furnace would incorrectly imply that it is an asset with a negative value merely because it falls into the category RC > PV > NRV. Such absurd valuation could persist for many years, given relatively long fixed-asset lives.

(b) If in the case RC > PV > NRV an asset is valued at NRV, the process might well be lengthy, costly and open to manipulation of income. That is to say, a firm could 'increase' the NRV of its end-of-period assets relative to its beginning - of - period assets simply by searching more diligently for the best market price at the end of a period than it did at the beginning. In effect, there is no 'given' net resale price; hence it is difficult to see what NRV 'market valuation' means in such a situation.

Professor Stamp, opposing the use of PV in asset valuation asserted: "According to our rule, value to the firm would be economic value; but I suggest that since this is a subjective and non-measurable quantity, we would not go far wrong in most

instances if we treated value to the firm as a net realizable value....."[20] In such circumstances, NRV certainly appears to have great virtue of practicability, but the virtue is minimized by the weaknesses of its use exemplified in (a) and (b) above. Professor Stamp's comment above is an expression of the measurement difficulties involved in present-value accounting. Other opposers* of present value as a general valuation basis state that present value is an anticipatory and subjective notion based on management's expectations of future events. Hence, they see it as unsuitable for measuring past economic performance and current financial position.

(2) The present value measurement concept is a 'pure' valuation. Valuations are subjective, comparative, temporal, anticipatory and beyond inquiry. This point is similar to those preceding. (1)

(3) Economic income and present value are ex ante, while a concern for perfomance implies ex post measures of profit and finacial position. For this reason, present value cannot throw light on performance.

(4) It does not preserve the distinction between income and holding again. In other words, the essential feature between income and capital gain is disregarded. All gains (realized and unrealized) are taken to the profit and loss account.

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* The other opposers to present value include Cee and Peasnell, already referred to. (See reference No. 19 at end of this chapter).

(5) It may be possible to get subjective present values of individual assets, and hence the sum of their total value to the firm, viewed as a whole. The approach of valuing the firm through the determination of present value of each individual asset may either result in under-valuation or over-valuation of the firm.

Conclusion: As far as the balance sheet is concerned, it is the view of the Sandilands Committee (p. 153) that "present value accounting will only prove useful to those companies the value of whose assets and liabilities is their 'economic value'. These will in the main be companies in the financial sector, particularly insurance companies".

3-2-3 Net Realizable-Value Accounting

Net realizable value, in relation to an asset, means the highest amount that could be obtained from selling the asset, after deducting all expenses of sale. The concept is likely to be appropriate to those concerns which contemplate termination of business. If a firm anticipates selling its existing machines, the valuation of the machines on the basis of net realizable value would be most appropriate.

However, the valuation of an asset on the basis of its current NRV should not necessarily imply any intention to sell the asset.

Net realizable value is a market value (i.e., a market validated measure) just like replacement cost. The difference between the two is that NRV is an output value while RC is an input value. According to Chambers,[21] all non-monetary assets at the end of each period are valued at their current market resale prices (i.e. at their money equivalents). He argues that in a world of rapid and accelerating change, the best index of business strength is its ability to switch the form of its asset holdings in the market. Commenting on realizable values, Langdon has stated:

"Using the current exit value basis of asset valuation, the question of what would be the cost of replacing a group of assets is not asked; rather, a determination is made of the cash value (or money equivalent) the assets would have if they were sold off which, in the case of non-monetary assets, would most likely be their resale value..... These output prices are not prices based on liquidation considerations (or other sales under situations of duress) but rather are prices based on external or independent evidence which can give a good approximation of the market value of the asset!"[22] This output value is to be determined by the market place, and the resultant figure represents the true capacity of the firm to change its direction and to meet its financial obligations.

The PV (or 'user value') is not as accurate as the market value because it incorporates some assumptions about the future which can be very subjective, such as the future consumer

preferences, economic life of an asset, and the like. Unless the reader of the financial statement is made aware on what these assumptions are, faulty conclusions concerning the performance of the firm can result.

Distinctive Qualities of Net Realizable Value

(1) Assets are valued in the accounts by reference to their current resale values.

(2) All figures in the financial statements are referenced to the date when the financial statements were prepared. Successive financial statements are not comparable in respect of absolute amounts since they are in differently dated shillings. The book value of an asset at balance sheet date of June 30, 1975 relates to net realizable value of the asset at that date. The net realizable value of the same asset in June 30, 1976, is likely to be different in both purchasing power of money, and in actual figures, from the June 30, 1975 figure. But the ratios derived from successive statements may be comparable since a ratio is a pure number or percentage and the ratios for a dated set of statements are proper ratios.

3.3 Current Value Accounting and Price Level Accounting Contrasted - A Critique

Fairly detailed evaluation of current-value accounting and price - level accounting has been given in the above analysis. But we have not made any recommendation as to whether price-level

accounting or current-value accounting is a better method for accounting for inflationary effects. A comparison of the two systems is made below under various topical headings. Each element of comparison expresses or implies the better of the two systems for each considered function. Our main objective is to ensure that, having regard to changes in costs and prices, financial reports of accounting entities (in measuring performance in relation to resources employed) are relevant, realistic and of maximum use to shareholders, creditors, management, and to other interested parties having reasonable rights to such information.

According to Ian Tilley, an accounting system (or theory) can be acceptable if it gives affirmative answers to the following questions:[23]

(1) Does the theory rest on realistic assumptions?

(2) Is it internally consistent?

(3) Does it represent the simplest, most readily understood explanation of the field?

(4) Does it have the greatest predictive value of all competing theories?

(5) Does it meet the goals of accounting? In other words, does it produce reports which satisfy the information needs of the users of accounting reports?

"These tests", Tilley continues, "are quite conventional ones in the area of theory testing and, although they may not constitute a total evaluation, they are certainly adequate".

The comparison of price-level accounting with current-value accounting below includes most of the above tests.

(i) Capital Maintenance & Profit Measurement

Price-level accounting aims at maintaining capital in terms of constant purchasing power. In other words, it aims at keeping shareholders' equity adequate to purchase a very wide variety of goods and services, or to purchase goods and services the prices of which have moved in line with the general level of prices. Profits are said to be available for distribution after maintaining the purchasing power of capital. Such a concept is only appropriate for organisations whose expenditure pattern satisfies and is likely to continue satisfying such conditions. Modern industry has, however, variant expenditure patterns for which the concept cannot be appropriate.

Current-value accounting is aimed at maintaining the operating capacity of a firm. Profit is defined as the amount available for distribution after having maintained intact the the asset resources, both physical and monetary, which are needed to retain the existing potential of the entity for providing goods and/or services. This does not necessarily mean that assets used up in operations will be, or will not be replaced with other identical assets. R. Hill states that "although the application of a general price index is needed to offset distortions caused by changes in the value of money, only by accident and design can a general price revision maintain the

physical resources of the enterprise intact - it does not show the amount to be distributed without eroding capital. To do that would require the recognition of replacement cost of specific assets"[24]

(ii) Valuation of data in Financial Statements

Current-value accounting values the items in the financial statements with reference to their market values, or by applying specific price indices. Price-level accounting applies a general price index to adjust the historical costs of the items in the conventional accounts. The proponents of the former system contend that current values are more relevant for future predictions and for appraising management performance. They oppose the use of a general price index in adjusting the historical costs by arguing that the indices of various assets do not necessarily move in the same direction or in the same degree of magnitude with the general price index. A general price index which can be appropriate for use in all types of entities is non-existent. Firms are affected by changes in the prices of the commodities in which they deal rather than by changes in prices in general. It is not feasible to tailor the general price index to suit all the firms. For those reasons, the contention is that current-value accounting tends to be more realistic. Depreciation charges based on the current values of assets at balance sheet date are also more realistic than the charges based on the price-level adjusted values of assets because the latter might be a result of applying an inappropriate general-price index.

(iii) Problems of Classifying Assets

The adjustments of items in the financial statements require that assets should be classified into monetary and non-monetary assets. This is not easy particularly when it comes to classifying deferred taxes, deferred investment tax credits, and debts denominated in foreign currencies. It is very difficult to judge whether a marketable security is monetary or non-monetary, unless it is clearly disclosed by the firm concerned.

Current-value accounting does not entail the above stated problems because most valuations are made with reference to current market values.

(iv) Departure From Historical-cost Accounting

Price-level accounting is not a departure from traditional historical-cost accounting. It adjusts the historical costs using a general price index, and thus it is an extension of historical-cost accounting. For this reason, price-level accounting does not eliminate most of the flaws of historical-cost accounting. It is not an alternative system but it is a modification and extension of historical-cost accounting. It retains the problem of aggregation to the extent that a suitable general-price index cannot be found. Money units incurred at different dates may not be accurately adjusted to remove the mixture of money units of different values that exists under historical-cost accounting.

Current-value accounting places values on assets by referring to their current market value or by use of specific

price indices, whichever is the more appropriate. It is an alternative to, and not a modification of historical-cost accounting. It thus removes most of the distortions created by historical-cost accounting. It avoids the problem of aggregation. The total asset figure at any balance sheet date show money units of the same value at that time..

(v) Handling Intangibles

The treatment of intangible assets is the most disregarded in traditional historical-cost accounting. A mere adjustment of historic cost under price-level accounting may hardly improve the treatment of the intangibles. Bowes and Searle et alia state that "the accounting for intangibles represent the least considered area in the entire accounting process with greatest possibility for diverse results."[25] They added that "in considering the benefit side, the current-value system may provide an acceptable answer to recognition of intangible property values." It is, however, doubtful as to whether current-value accounting will give any better recognition of intangibles than historical-cost accounting. How can one revalue goodwill in current terms? The attempt to revalue goodwill necessitate revaluing the whole firm, something which is beyond the scope of current-cost accounting. This might result in internally generated "goodwill", and this would be counter to Generally Accepted Accounting Principles. Copyrights, patents, trademarks, and other intangibles create similar valuation problems as exist for goodwill.

It seems therefore that all intangibles would not be valued differently in the current-value accounts from the values shown in the conventional accounts. In other words current-value accounting will not likely affect the valuation of intangibles. Alexander and Barrington[26], also believe that intangible assets can be shown on financial statements at a nominal value. They state that these intangibles 'can be valued', but the problems of valuation are considerably greater than those encountered for physical assets.

(vi) Objectivity and Relevance

The supporters of historical-cost accounting claim that this system is objective, i.e., that you can verify the cost of an asset by referring to an arm's - length transaction. The proponents of price-level accounting argue therefore that since price-level accounting adjusts the historical costs, it retains the objectivity of the asset values. This argument is subject to debate, taking account of the fact that an item such as annual depreciation is a result of a subjective opinion of the management as to the estimate of the life of the fixed assets. Auditors also support the objectivity of the historical-cost accounting but they do not agree that price-level accounting retains that objectivity.

The opponents of current-value accounting claim that the system is quite subjective, particularly when it comes to valuing units whose equivalent assets are not traded in the market.

Such assets include complex assets such as blast furnaces. It is argued that valuation of such assets is mere guesswork and that such valuations may be very biased and subjective.

The main argument is whether the present financial statements users require cost figures which can help them to assess correctly the performance of management, the prediction of future events, and the relevance of the day-to-day management decisions. If we accept that current values are more relevant for good decision-making and for prediction, then it would pay to introduce some subjectivity in valuing assets rather than sticking to the objective historical costs which may be of little value to good decision making and for predictions about the future. Current values tend to have more relevance to the current demands of users of accounting reports. Price-level accounting aims at keeping constant the shareholders' equity and not at improving the bases of prediction.

(vii) Price Index Problem

Price-level accounting makes use of a general price index. Current-value accounting determines the values of assets by referring to their current market values or by using specific indices, where these indices are found to be more appropriate. As we have already seen (see point (ii) above), there is no one appropriate general price index for all firms. Apart from the problems of weighting, a general price index is distorted by changes in tastes, price controls and rationing by government, and

by subsidies and taxes introduced by government. Taking Kenya as an example, which index is appropriate to all industries and companies: Upper income index? Middle income index? Or Wage Earners' index? Even if we chose, say, the Middle income index as a fair index for adjustments, we must not ignore the problem of compiling the required data, and the problem of defining the items consumed by middle income earners. Prof. Bell, in his article, quoted Mathews who stated that: "Data which are measured in different units to begin with cannot be converted to a common basis of measurement merely by applying a common convenient factor ....." [27]

Current-value accounting can use internally prepared specific indices, which can be easily worked out by each company.[62] Companies can also use specific indices prepared by the government, e.g., on the cost of building materials.[62]

(viii) Maintaining Enough Funds For Replacement

Current-value aims at retaining enough funds in the firm for replacement of assets. This is achieved through matching current costs to revenue. During inflation, such a practice reduces the amount of profits distributable to shareholders. The higher depreciation charged against the revenues reduces the reported profits considerably. Assuming that holding gains or realizable cost savings are treated as non-distributable equity adjustments, a firm will be able to retain enough funds for replacements. In many cases, however, separate decisions are made to set aside

funds for replacement. Price-level accounting does not precisely aim at retaining enough funds for replacement of worn - out assets. It is, however, likely that greater retention of profits will be made if the system does not include holding gains as part of the distributable profits. Otherwise, the system normally regards holding gains as part of business income while current-value accounting does not.

(ix) Comparison of operations within a company, and also between different companies

Both price-level accounting and current-value accounting systems are claimed to improve intra-company and inter-company comparisons in terms of their operations performance. The former system states accounting data in terms of constant purchasing power. This makes it possible to compare the performance of a company in a given period, the performance between the last balance sheet date and the previous dates. As long as the past accounts are 'rolled forward' using a general price index, it becomes possible to compare performance between various past periods. Such comparison is also possible between different companies. But a problem exists when we take into account the fact that different companies have different balance sheet dates. Some prepare their final accounts on 30th June, some 30th September, some 31st December, and some 31st March of any year. Even if you roll forward the previous data, how satisfactory or meaningful is it to compare the performance of different comapnies with different balance sheet dates? This is not likely and it is equally

unlikely that all firms can be compelled to have the same balance sheet dates.

Current-value accounting states its data in current values, with reference to the market. This can show the true performance of a firm at a given balance sheet date, but it does not improve comparisons between the past periods and the current period. It also does not resolve the problem of comparing performances of companies whose financial years end at different dates, because the monetary unit has different values and cannot thus be validly compared unless prices are stable.

While comparisons between different past periods are improved by updating past data using the general price index, this comparison is inhibited by the fact that the relative amounts of assets and liabilities vary from year to year in any company, and also between various companies. Some assets could have been disposed of while others could have been acquired. A mere adjustment of 1974 accounts to 1975 purchasing-power terms cannot give any easy solution to comparison between the operations in two years if relative assets and liabilities have been altered.

(x) Measurement of Performance

Internal and external appraisal of a firm is important. It is the way by which management can assess its performance, and also the way in which management's actions can be assessed by investors. Managers have to make operating and investment decisions. A good measurement system recognizes this distinction and guages performance in ways that allow both types of decision

makers to evaluate the effectiveness of their actions. A good measure of operating performance captures 'what really happened' and eliminates all the statics in the environment. Thus managers running plants of identical physical capacity should be charged the same amount of depreciation. The difference in their operating profits is then due to effectiveness in their decisions.

Investment performance is commonly evaluated by calculating the rate of return on investment (ROI). Even without inflation, ROI has serious flaws, and inflation complicates matters further under historical-cost accounting.

Investors and other external users of financial reports would prefer a system that reflects a true or fair figure of ROI. Price-level accounting, being an adjustment of historical-cost accounting, does not improve the evaluative measure greatly but at least it makes a positive difference. ROI and other ratios like 'assets per share', and 'earnings per share' are fairly improved by the use of both price-level accounting and current-value accounting systems.

Current value accounting tends to be of greater value when management are making current decisions. For example, when management wants to sell, say a machine, net realizable value is important. If the machine is to be replaced, then replacement cost is important. If the use of the machine is to be continued, then its economic value (or present value) to the business - its reliability and its output - is important. These are all current

values. This applies equally to decisions about inventory. Management constantly works with current costs and values when making decisions and taking actions. It seems reasonable, therefore, to expect accounting records, management reports, and financial statements to reflect these current values.[28]

(xi) Internal Consistency

Under historical - cost accounting, rapid depreciation methods may be used. These methods, such as the double - declining method, tend to produce high depreciation charges in the early part of the asset life. As the life of the asset approaches its end, the depreciation is quite low if not nil. Ignoring the maintenance costs and repair costs, such a practice tends to overstate depreciation charges at the initial stages of the asset life and understate the depreciation charges at the end of the asset life. This is a rather inconsistent measure of depreciation particularly if the asset life is initially miscalculated. Depreciation charges may be too low in later years when in fact the operating capability of the asset is pretty high. What management or accountants normally do is to revise the asset life and then adjust the depreciation accordingly. This may, however, result in mistated profits, and hence the mistatement of rate of return on investment (ROI), earnings per share, assets per share and retained earnings for the accounting periods before the asset life is revised. Price - level accounting does not solve this problem of inconsistency; instead it complicates it. Current - value accouting, however, solves the problem because the

depreciation charge is based on the current value of the assets as at balance sheet date. The ROIs, earnings per share and other ratios are then fairly stated in the accounts.

(xii) Realism of Assumptions

Historical-cost accounting assumes that the value of money does not change even during periods of unstable prices. Both price-level accounting and current-value accounting do, however, remove this assumption. Price-level accounting assumes that there is one valid general-price index that can be appropriately applied in adjusting data of various industries. This assumption tends to reflect too simple a solution to inflation accounting. As we have already seen above, such a universally applicable index hardly exists. Price-level accounting also often assumes that most expenses, purchases, sales, and revenues take place evenly during any given year. This assumption may be appropriate for manufacturing industries but not for agricultural industries which are commonly faced with seasonal fluctuations. These latter industries experience more business when the weather is good than when it is adverse.

Current-value accounting assumes that it is possible to measure the replacement cost of specialised assets. However, it is highly unlikely that replacement cost of a unique plant or machinery can be determined. This system also assumes, when applying present values, that it is possible to project future cash flows associated with each specific asset. This is rarely true in real life. When applying replacement cost as the basis

of valuing assets, the system creates a wrong reflection that an entity will continue to operate in the same line of business indefinitely. It also assumes that the firm will replace an asset with an identical asset, thus implying that the firm will continue to manufacture existing products without change or substitution. This is not necessarily true in real life. A dynamic environment encourages firms to change or modify their businesses constantly.

To sum up, the foregoing comparisons between price-level accounting and current-value accounting are not exhaustive, but they tend to show that current-value accounting is more realistic after some of its problems have been resolved. The main objectives of current value accounting are to show current value of balance sheet items and also to produce a realistic measurement of profit available for distribution. Price-level accounting aims at showing data of the same purchasing power in financial statements, and also to maintain the shareholders' capital. It has been suggested that a combination of both current-value accounts and price-level accounts would be an ideal system for inflation accounting. But in considering the problems encountered in producing the two sets of accounts, the author does not foresee the acceptance of the combination by the accounting profession. Moreover such a combination is most likely to create even more confusion and lack of understanding than either of the two systems separately. It would, in addition, be very expensive to produce a combined set of the two systems. The benefits to be gained would likely be less than the costs.

SECTION II: HISTORICAL DEVELOPMENT ON INFLATION ACCOUNTING

The tempo of comments on the effects of inflation seems to be accelerating. Henry Sweeney made the earliest proposal on how to deal with price-level changes in 1936. His proposal was intended to expound what has since been called 'economic income', which requires:

(a) recognition of gain or loss on monetary items, and

(b) charges for such items as plant utilization, which represents the current economic value consumed.

The latter element, (b), is to be accomplished by making appraisals or by applying replacement cost numbers.

As we shall see below, various professional accounting bodies and committees set up by governments have made tremendous progress? moves towards implementing the proposed methods of inflation accounting. They have shown great interest in trying to help the accounting profession but until recently, these bodies have been loathe to depart from the 'objectivity' of historical-cost accounting. Much has been said in the literature about this debatable area of accounting, but little has been put into practice.

Some of the bodies, such as the Accounting Principles Board (APB) and the Financial Accounting Standards Board (FASB) both of the U.S.A. have advocated adoption of price-level accounting, while other bodies, including the Sandilands

Committee(U.K.) and the Mathews Committee (Australia) have advocated current-value accounting. This indicates that there is no universal acceptance of one best approach to accounting for price-level changes. Even those who argue for price-level accounting disagree on the selection of a general-price index which can appropriately be applied to all industries and companies. The discussion below deals with the accounting bodies and committees of a number of countries and their contributions to inflation accounting.

3.4 Developments in the United Kingdom and Ireland

The U.K. and Ireland have made remarkable contributions to the deliberations on inflation accounting. Both Institutions of chartered accountants, and committees set up by the U.K. Government, have made notable contributions as we shall see below.

(a) Institutes of Chartered Accountants

The subject of inflation accounting has been under discussion within professional accounting bodies for at least 30 years.[29] The first formal pronouncements by the Institute of Chartered Accounts in England and Wales on the effect of changing price levels on accounts appeared in 1949 in Recommendation No. 12.? In May 1952 the Institute issued further Recommendation No. 15: "Accounting in relation to changes in the purchasing power of Money", which discussed the problem in greater detail and examined some of the methods of full-scale inflation accounting, including the index method of adjusting

accounts to reflect the changes in purchasing power of money. The Institute of Chartered Accounts of Scotland made a similar recommendation to its members in 1954, During 1952, the Institute of Cost and Works Accountants and the Association of Certified and Corporate Accountants both published books which advocated accounting for price-level changes mainly on a replacement-cost basis. In 1968, the Research Foundation of the Institute of Chartered Accountants in England and Wales published a paper entitled "Accounting for Stewardship in a Period of Inflation". This paper discussed the impact of inflation on companies and described in some detail the practical procedures required to adjust accounts for changes in the 'purchasing power' of money. Since the publication of the Statement of Standard Accounting Practice No. 7 (SSAP7), which is discussed below, both Recommendations No. 12 and No. 15 of the Institute of Chartered Accountants in England and Wales have been withdrawn.

(b) Committees

There are four committees, among others, which have made significant contributions in the field of inflation accounting. These are:-

(i) The Accounting Standards Committee (ASC) - initially called the Accounting Standards Steering Committee (ASSC) up to February, 1976.

(ii) Boothman Committee

(iii) Sandilands Committee

(iv) Morpeth Committee.

The Accounting Steering Committee (ASC)

This is the Accounting Steering Committee of the Institute of Chartered Accountants in England and Wales, in association with the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

The ASC (or ASSC before February 1976) issued for comment Exposure Draft No. 8 (ED 8) entitled "Accounting for Changes in the Purchasing Power of Money" on 17th January 1973. This document created increasing debate on inflation accounting throughout 1973 and the first part of 1974. The debate was intensified by the issue of Statement of Standard Accounting Practice No. 7 (SSAP7) on May 14th, 1974, by the professional accounting bodies under the same title as that of ED 8.

Both ED 8 and SSAP 7 recommended the use of a general-price index for adjusting historical costs for price-level changes. SSAP 7 required companies to supplement their conventional accounts with statements demonstrating the effect of 'Changes in the Purchasing power of money on accounts prepared on the basis of existing conventions'. This standard was provisional, i.e., it was not mandatory upon companies to prepare such supplementary statements.

The main features of SSAP 7 are:[30]

(a) Companies will continue to keep their records and present their traditional annual accounts in historic pounds (or shillings), i.e., in terms of the value of the pound at the time of each transaction or revaluation;

(b) All listed companies should, in addition to issuing conventional statements, present to their shareholders a supplementary statement in terms of the pounds at the end of the period to which the accounts relate;

(c) The conversion of the figures in the traditional accounts into the figures in the supplementary statement is to be achieved by means of a general index of the purchasing power of the pound.

(d) The Standard requires the directors of a company to provide, in a note to the supplementary statements, an explanation of the basis on which they have been prepared; and it is also desirable that directors should comment on the significance of the figures.

The Sandilands Report (see p. 120) asserts that "the SSAP 7 backed by the professional accounting bodies who have issued it, has gained considerable support among companies as a practical method of accounting for inflation".

Note that the variations between proposals for practical application of the purchasing-power method in the U.S.A., and in the U.K. and Ireland arise from the choice of items in relation to which 'purchasing power' is to be measured. The Financial Accounting Standards Board (FASB) of the U.S.A. issued an exposure draft entitled, "Financial Reporting in Units of General Purchasing Power"[31] on 31st December, 1974 which proposed that, for the purposes set out in it, the 'purchasing power of money' should be related to the 'power of money to purchase all items

of goods and services' and hence the use of the term "general purchasing power" (GPP). The exposure draft also recommended that general purchasing power information should be stated in terms of the general purchasing power of the dollar (U.S. money) or, here in Kenya, of our Kenyan shilling at the most recent balance sheet date. Like the FASB exposure draft, SSAP 7 (in the U.K.) recommends that information should be shown relating to the 'Purchasing power of money at the current balance sheet date.'
For this reason, SSAP uses the 'Current Purchasing Power' (CPP) term.

In contrast to the FASB exposure draft, SSAP 7 recommends that changes in the purchasing power of money should be measured in relation to items purchased by individuals (or individual consumers) for their own personal use, not to all items of goods and services, which the FASB exposure draft in fact implies in its proposal. SSAP 7 is, therefore, not based on an attempt to measure changes in the general purchasing power of money as is the case with FASB exposure draft. There is, however, no difference in principal between the two proposals. Their similarity is implied in this thesis in regard to the price-level accounting system.

The Boothman Committee

In July 1975, the Accounting Standards Steering Committee was set up under the leadership of Boothman. It published a 'Corporate Report' commonly known as the Boothman Report.[32]

This report is similar to the Treublood Report which is discussed briefly in the Australian Accountant Journal of 1974.[33] The Boothman Report stresses at the outset its concern with user needs. It states:-

"Our basic approach has been that corporate reports should seek to satisfy, as far as possible, the information needs of users: they should be useful. To identify their needs and thereby arrive at the fundamental objectives of corporate reports, it is first necessary to determine who should publish corporate reports, and why ".[34]

The Boothman Report asserts that all entities of significant size have an implicit responsibility to report publicly on their affairs for the general information of all users outside of those charged with the control and management of an organization. In addition to the above, the report reviews the positive contribution of corporate reports with respect to:-

(a) evaluating the performance of an entity and that of its management;

(b) economic stability and vulnerability of the entity;

(c) future predictions of prospects, etc.;

(d) compliance with taxation regulations, etc.;

(e) making economic comparisons (i.e. inter - and intra - comparisons) of the operations of companies;

(f) ascertaining ownership and control;

(g) assessing liquidity of a company; and

(h) ascertaining the experience and backgound of company directors and other officials.

The report regards companies as having multiple responsibility to investors, to shareholders, to employees, to management, and to society at large.

Commenting on historical-cost accounting, the Report states that 'the defects of the historical-cost system under inflationary conditions can be ameliorated by the use of general index adjustment techniques'.[35] It recommended adjustment of historical cost in the manner recommended in SSAP 7; and it went on to say that the adjusted statements should not be reported as supplementary statements, but rather that the two statements should be accorded equal status.

The Boothman Committee felt that current-value methods of measurements, accompanied by the use of a general index adjustment, will in time prove to offer superior means of measuring performance and position. The Report does not, however, have a concise central view of the objective of business enterprise. Some writers, including Peter Sandish[34], argue that the Report does not state which version of current valuation it had in mind. These writers argue that the adoption of the Boothman Report's recommendations would result in a major expansion of the range and volume of data appearing in corporate reports, and this would increase the cost of preparing the reports further.

The Sandilands Report[36]

This is the most recent report which has aroused much debate all over the world. The Report was prepared by the

Inflation Accounting Committee headed by F.E.P. Sandilands, and was published in September 1975. The Sandilands Committee was set up because of the issue by the ASSC of the Exposure Draft No. 8 on January 17, 1973. The draft was published on June 25, 1975. Its terms of reference are wide-ranging. It has made various criticisms about the CPP method which had been recommended by the ASSC and SSAP 7.

The Sandilands Report based its approach on:

(1) an analysis of historical-cost accounting;

(2) an examination of the effects of price changes on conventional accounts;

(3) an examination of the recommendations made by SSAP7; and finally,

(4) the formulation and presentation of recommendations for the adoption of current-cost accounting to remove some (if not all) of the flaws of conventional accounting.

The Report concludes that an inflation accounting system should show the specific effects of price changes on an individual company. It states that recent developments taken as a whole have led to inconsistencies, and lack of comparability because of the ways in which different companies draw their accounts. The Sandilands Report acknowledges the valuable short-term service performed by the professional accounting bodies in recommending the CPP method for inflation accounting.

The Report attacks the CPP method for various reasons:

(1) The Report contends that the proposal in SSAP 7 that CPP statements should be supplementary to historical-cost accounts of a company is likely to detract significantly from any usefulness

the CPP method may have.[37] A statement which is supplementary in character will inevitably have less impact on the leaders or on the directors of the company concerned than will a change in the conventions used in the accounts themselves.

(2) It is made clear in SSAP 7 that the Retail Price Index (RPI) was chosen to adjust historical costs because it was regarded as the best available indicator of changes in the general purchasing power of money to consumers.[38] This inevitably implies that those users of accounts who are not primarily to be regarded as individual consumers will find CPP supplementary statements of limited relevance to themselves. This is one of the proofs that the current purchasing power unit is not equally useful to all users of accounts.

(3) The CPP statement which is appended to historical-cost accounts retains the elements of historic cost and the inherent flaws of historical-cost accounting.

(4) The CPP statement fails to show a company's 'operating profit'.

(5) The CPP method is potentially misleading by including net gains on monetary items which exist only in terms of current purchasing power units and not in terms of monetary units.

(6) CPP method shows the extent to which the purchasing power of a shareholder's investment has been maintained but in a form which is not useful to him for any practical purposes. It could be useful if such equity must ultimately be returned to the shareholder.

The Report makes other criticisms on CPP method which the author is not able to include here. In conclusion then, the Report states that the CPP method does not provide the best long-term solution to the problem of accounting for inflation because it does not remedy many of the deficiencies of historical-cost accounting, and because it introduces a further set of problems by expressing accounts in terms of a new unit of measurement. Most of the above criticisms of the CPP method are valid, although the Sandilands Committee tended to over-criticize without taking account of the fact that the SSAP 7 recommendations were the first of their kind and made prior to any other developments . .

The Sandilands Report recommends the adoption of current-cost accounting whose features are discussed below.

Recommendations of Sandilands Report[39]

(1) Accounts should continue to be drawn up in terms of the monetary units (e.g., pounds sterling in the U.K. or Kenya Shilling in Kenya). Thus no holding gains or losses should arise from holding monetary assets.

(2) The valuation of assets in the balance sheet should be based on the 'value to the business' approach. The principle underlying this approach is to value each tangible asset of a going concern at the sum of money that the firm would lose if it were to be deprived of that asset and thereafter took action to minimize the loss it had sustained.

The Sandilands Committee acknowledges the fact that some

companies do revalue their assets, albeit irregularly and in piecemeal fashion, at balance sheet date. This applies particularly to the valuation of property assets. The Report recommends extension and standardisation of these companies' practices.

(3) A best estimate of 'value to the business' of a company's assets should be achieved with but a reasonable outlay of resources. This, of course, will vary with circumstances surrounding a given business. Such estimates provide more useful information than do the precise figures of historical-cost accounting.

(4) To the Committee, a system of accounting based on the measurement of assets by reference exclusively to RC, NRV or PV is too restrictive and, while useful for certain purposes, is unlikely to be as useful for the majority of users as a system based on the 'value to the business' concept.

(5) A good valuation of tangible assets (normally referred to as 'tangibles'), as recommended by the current value accounting system, is dependent on the experience employed in the valuation process.

The Committee, however, declined to contemplate any change from the historical-cost basis of measuring intangibles. "The problems of estimating the current 'value to the firm of such assets are significant' the Committee asserted.

(6) The Committee was not in favour of the principle that liabilities should be shown in balance sheets at their 'value to the business'. Because of the foreseeable and inherent

difficulties of revaluing liabilities, the Committee declined to propose any immediate change in the way liabilities are shown under the traditional accounting system. The Committee recommended a further study on the treatment of liabilities under Current-Cost Accounting.

(7) Operating-cost profit (termed as 'Current Cost Profit') was believed to be most useful to the majority of the users of accounting reports. The Committee recommended that a figure of current-cost profit before and after tax should be shown in the company's accounts. The concept of current-cost profit requires that annual provision for depreciation should be calculated as an appropriate proportion of the 'value to the business' of the company's fixed assets. It also requires a change for stock (or inventory) consumed at the time when these stock is being used up during the year. This means that 'stock profits' (or 'stock appreciation') of recent years would no longer flow through the income statement.

(8) The charges for labour, interest, expenses save depreciation, and cost of sales reflect value to the business if wages, salaries and interest and, in the opinion of the Sandilands Committee, the items (i.e. wages, salaries, etc.) require no adjustment. "In particular, there is no need to adjust interest charges to reflect current rates of interest"; and the Committee added, "The value to the business of an interest payment is equal to its cost amount, whether the rate of interest is above or below current market rates"[40].

(9) A statement showing the sources and uses of funds should be attached to companies' published accounts. The Report emphasizes that, during a time of rising prices, it is essential for a company to keep its liquidity position under regular review and a funds statement will show the movement in the net liquidity position in the year the accounts are prepared.

(10) The net book value of assets and depreciation on an historical basis should continue to be shown in notes to a company's current-cost accounts.

The Sandilands Report has received both commendations and criticisms. The Report deserves credit for its comprehensive and brave recommendations - the only ones of their kind. It has given the accounting profession an impetus and has reflected the hopes of implementing the suggested methods of inflation accounting. As Merret and Sykes have stated, "The most remarkable achievement of the Sandilands Committee is that in this most complex of subjects it has arrived at fundamentally sound and important conclusions without compromise or concession on essential issues; it represents a very considerable achievement in its own right, and even more by the standards of post-war Committees of this kind....."[41]

The Report has also encountered many criticisms from both academic and practising accountants. The main criticisms include the following:-

(1) The Report lacks empirical research. It is based on opinions. As Fisher puts it, "the choice of the concept of

profit and capital maintenance is based merely on expression of opinion and has not been subject to empirical investigation..... The current accounting system proposed by the Sandilands Committee should be tested to find out whether users of financial statements prefer asset measurement based on the basis of 'value to the business'.[42]

(2) Treatment of Holding gains:- The Sandilands Committee recommended exclusion of holding gains and extraordinary items from the profit and loss account. The Committee argued that these two items will be recorded through revaluation reserves and disclosed in a statement of total gains. Many accountants have opposed this recommendation by stating that the grounds for excluding such gains from profit and loss account are unnecessarily weak. Merret and Sykes state that this treatment amounts to nothing more than the statement that:-

(a) the profit and loss account without such gains might be a better basis for prediction, and

(b) that such gains might not be 'available for distribution''[43].

Merret and Sykes also add that the Report lacks empirical evidence (a central weakness) and that its conclusion simply rest upon the above statements (a) and (b) as expressions of opinion. (cf. argument (1) above). The second argument of Merret and Sykes is that"..... even if both propositions(i.e., (a) and (b) above) were true, it would in no way prove that a profit and loss account excluding such gains should form the basis of price control, government contracts, or taxation as the committee

recommends".[44] On this issue of holding gains, Fisher comments that little consideration was given to an all-inclusive concept of profit. Professor Morley also criticises the Report for its failure to show the holding gains explicitly.[45]

Morpeth Committee

An 'Inflation Accounting Steering Group' was set up in January 6, 1976, under the chairmanship of Mr. D.S. Morpeth, to study the feasibility of implementing the Sandilands Recommendations, and also to work out the procedures for implementing the recommendations. The Morpeth's Committee's working timetable was as follows:[46]

September 30, 1976	----------	Submit a proposal for an exposure draft to ASC.
November 30, 1976	----------	Exposure draft to be published by ASC for comment by February 28, 1977.
During March, 1977	----------	Analyse the comments
March 31, 1977	----------	Start producing a Standard Accounting Practice.
July 31, 1977	----------	Submit the Standard to ASC
September 30, 1977	----------	ASC to submit the Standard to Councils of participating bodies.
October 31, 1977	----------	Publish the Standard

The Committee was divided into five working parties namely, A, B, C, D, & E, in order to facilitate the total work of

Committee.

The functions of each working party were as follows:

Working Party A --- to examine the valuation of assets by Sandilands Report.

Working Party B --- to examine the valuation of stock and work-in-progress, and the calculation of cost-of-sales adjustments.

Working Party C --- to study the legal problems of implementing current-cost accounting.

Working Party D --- to work out the guidelines for the implementation of current-cost Accounting.

Working Party E --- to consider the initial reactions of the Consultative Committee of the Accountancy Bodies (C.C.A.B.), in addition to examining the treatment of monetary items, etc. recommended in the Sandilands Report.

The Morpeth Committee appears to be working as per their timetable, except that they have extended the exposure period from three months to six months (see below). On 30th, November, 1976, the Committee published the proposed Standard of Accounting Practice (Exposure Draft No. 18) for comment, and its period of exposure has been extended from three to six months, expiring now on May 31, 1977. This means that the other formally planned periods may be moved forward accordingly. The draft follows, very closely, the recommendations put forward by the Sandilands Committee although it differs on the controversial issue of the monetary items in company accounts.[47] Monetary assets and

liabilities are to be shown in the balance sheet at their face value. An adjustment will not be made in the profit and loss account, but the gain or loss resulting from holding monetary assets and liabilities will be analysed into its principal components and shown in the notes to the accounts. It is suggested in the draft that an appropriation account should be produced as well as the profit and loss account and balance sheet. The appropration account would show:

(1) the current-cost profit or loss for the year;

(2) surpluses or deficits for the year arising from the revaluation of assets;

(3) any amounts which the directors believe should be transferred to a revaluation reserve to maintain the substance of the business;

(4) dividends for the year; and

(5)the balance which is to be a transfer to or from the general reserve.

On the issue of the treatment of intangibles, the Morpeth draft states that these intangibles should be shown in the balance sheet at their value to the business only where this value can be established. Where such a value cannot be established for the intangible assets, they should be noted in the accounts although no value should be placed on them. Research and development expenditure carried forward should be valued on a current-cost basis.

As may be seen, the Morpeth Committee's exposure draft (ED 18) differs slightly from the Sandilands Report. The difference arises mainly in the treatment of monetary items, and

the handling of changes in shareholders' equity. The Morpeth Committee is making a very important break-through from the theoretical discussions on inflation accounting to its implementation stage as an accounting system. Current-cost accounting, recommended by the Sandilands Committee and now being implemented by the Morpeth Committee, seems to have a bright future because of its acceptance both in theory and in practice by the academicians and the practitioners. What remains now is working out the specific principles which should underlie the current cost accounting, if we accept that the G.A.A.P. have some fundamental weaknesses and that they are outmoded (see Chapter two). If the Morpeth Committee succeeds in its endeavours, it can open wide the gate for the accounting profession's advance on the subject of accounting for inflation.

3.5 Development in the United States of America

Further comments on this area of accounting have been advanced by the accounting bodies in U.S.A. It seems that the U.S.A. is lagging behind the U.K., Australia, Holland, and Canada in recommending the best methods of inflation accounting.

The following bodies have, however, made some good contributions to the debate on accounting for price-level changes:

(1) Accounting Research Study No. 6 (ARS NO. 6) and the Accounting Principles Board (APB), both of the American Institute of Certified Public Accountants (A.I.C.P.A.).

(2) The Financial Accounting Standards Board (F.A.S.B.)

(3) Others, including the Securities Exchange Commission (SEC).

Accounting Research Study No. 6 (ARS No. 6)

The APB of the A.I.C.P.A. met on 28th April,1961 and made a recommendation that the Director of Accounting Research be instructed to set up a project to study the problem of price-level accounting. A report had to be prepared in which reccmmendations were to be made for the disclosure of the effect of price-level changes upon the financial statements.[48] This recommendation led to the formation of 'Accounting Research Study No. 6'. The Study recommended the use of supplementary statements as a means of disclosure of the effect of price-level changes using general purchasing power method. It recommended the disclosure of the effects on all elements of financial statements. The Study, which was the first major study of the subject on accounting for price-level changes, was published in 1963 by the A.I.C.P.A. under the title "Reporting the Financial Effects of Price Level Changes". The major features of the study are as follows:

(1) It recommended that adjusted financial statements should be prepared supplementary to the conventional (historical cost) accounting statements.

(2) It recommended purchasing-power accounting, using the Gross National Product Price Index Deflator (GNP Deflator).

Thus the recommendation of ARS No. 6 were similar to those of ED 8 & SSAP 7 discussed in the earlier part of this section.[49]

The recommendations of ARS No. 6 also encouraged increased research into the problems of accounting for price-level changes.

Accounting Principles Board Statement No. 3

The Accounting Principles Board (APB) of the A.I.C.P.A. continued to explore the problem of inflation in some depth. In June 1969, the APB issued Statement No. 3 under the title, "Financial Statements Restated for General Price Level Changes". The Board's aim was to focus attention on the problem of price-level changes and to furnish guidance as to the methods to be used in adjusting conventional accounts for the effects of changes in dollar purchasing power. The Board felt that the degree of inflation in U.S. at that time was not sufficiently great as to cause the conventional accounts to lose their significance.[50] APB Statement No. 3 made similar proposals to those of ARS No. 6, but the former recommended in addition the adoption of the general purchasing power method by U.S. companies. Like the SSAP 7, APB Statement No. 3 was in favour of preparing supplementary adjusted accounts to the historical cost accounts. Otherwise the rest of the procedure of preparing adjusted financial statements is the same as that suggested by SSAP 7. The whole conversion process is the same as that stated in the earlier part of Section 1 of this chapter.

In general, the emphasis of both ARS No. 6 and APB Statement No. 3 is on the 'purchasing power' method as the best

approach to accounting for inflation. The APB argues that the restatement of conventional accounts for price changes does not attempt to deal with specific market changes. The Board alleges that adjustments for specific price changes do not deal with effects of inflation. It states that the effects of inflation are not treated if only specific price changes are recognized. The Board did not, however, clarify its conclusions, and it would seem that the conclusions were based on opinion rather than on 'tested' findings.

Financial Accounting Standards Board (F.A.S.B.)

The Financial Accounting Standards Board (F.A.S.B.) is the successor of the APB. On December 31, 1974, it issued an exposure draft entitled "Financial Reporting in Units of Purchasing Power". Comments on this draft were invited, to be submitted by September 30th, 1975. However, because of lack of good support of the draft, the FASB has not been able to issue a Standard on its proposals.

The draft proposed essentially the same method as that outlined in ARS No. 6 and APB Statement No. 3. The FASB position was quoted by Rosenfield as follows: "The general purchasing power of the dollar changes. The same dollar amounts in traditional financial statements can therefore represent different amounts of general purchasing power. Presenting information in units of general purchasing power avoids that problem. The same amounts in the restated financial information represent

the same amounts of general purchasing power rather than merely amounts of money whose general purchasing power changes!'[51]

The problem with FASB position is that no reason is given as to why financial data should represent amounts of general purchasing power rather than amounts of money. Also, it offers no means of choosing between its proposals and alternative ones.

Other Developements in U.S.

The Securities and Exchange Commission (SEC) and the American Accounting Association (AAA) have also contributed to the debate on inflation accounting.

In August 1975, a few days before the release of the Sandilands Report in September 1975, the U.S. Securities and Exchange Commission confirmed that it was thinking along similar lines as the Sandilands Committee. The SEC issued a draft of disclosure regulation that would require disclosure of the replacement value of inventories and plant in corporate annual reports in order to enable investors to make informed investment decisions.

The AAA's Committee on Concepts and Standards underlying Corporate Finance Statements issued its Supplementary Statement No. 2 in August 1951 which included a recommendation that adjustments should be made by using a geheral price index. The method proposed by the Committee placed emphasis on the ownership equity rather than on assets.

3.6 Developments in Australia and New Zealand

The trend of the development of inflation accounting in Australia and New Zealand tends to be similar to those in the U.K. The Australian professional bodies are actually following in the footsteps of U.K. bodies. Among the most famous contributions of the Australian bodies is that of the Mathews Committee, a Committee which is similar to Sandilands Committee. It brought down its report in May 1975.[52] In June 1975, the Australian Accounting Standards Committee (AASC) issued a 'Current Value Accounting' Preliminary Exposure Draft. This Draft is often referred to as the 'Australian C.V.A. Draft'. In January 1976, the Australian Accounting Research Foundation issued Exposure Draft No. 6 on the 'International Accounting Standard.' In October 1976, the AASC issued a 'Statement of Provisional Accounting Standards' on 'Current Value Accounting' the contents of which are similar to those of ED 18 of U.K.

The Mathews Report

The 'Committee of Inquiry into Inflation and Taxation', under the chairmanship of Professor Russell Mathews, was appointed by the Australian Government in late 1974.[53] For taxation purposes, it proposed indexation of depreciation charges and adjustment to current value of the cost of goods sold. Commenting on this proposal, the Security and Exchange commission stated that the approach of the Mathews Report would reflect the current value of capital consumed in the calculation of taxable income.[54] Commenting on the test which a good tax system should

Britain. In August, 1976, the CICA Accounting Research Committee issued a Comprehensive Discussion Paper on Current Value Accounting. Comments on it were requested from the members of the profession and from the business and academic communities by June 30, 1977. The recommendations in the Discussion Paper are in line with those of the Sandilands Report, and the Australian C.V.A. Draft.

In Germany, a Draft Recommendation was issued on December 15, 1974, by the Institut der Wirstchaftsprufer in Deutschland e.v' under the title "Accounting for the Purpose of Maintaining the 'Substantialistic Value' of an Enterprice." The position taken in the Draft was summarized by the CICA Discussion Paper as follows:- "The primary objective of the Germany recommendation is to provide supplementary information on how much of the annual profit may be distributed and still preserve the productive capacity of the enterprise given its existing capital structure. Under the proposed German method the information on the amount required to maintain productive capacity would be provided as part of the annual financial statements of all enterprises in the form of a supplementary schedule indicating the amount of 'fictitious profit' in proportion to profits..... Adjustments are required to net income for additional depreciation on fixed assets and for productive capacity maintenance in respect to inventories. Current entry prices are used to calculate these adjustments. However, the adjustments are made with respect only to the self-financed portion of fixed assets and inventory."[59] As can be seen, the German approach is similar to the previously

discussed Replacement Cost Accounting. In principle, replacement costs are to be used only for non-monetary assets that are marched by an amount of the shareholders' equity.

In Mexico, the Comision de Principios de Contabiladad (or Accounting Principles Committee) points out that the comprehensive application of a general price index to the accounts is not a violation of the historical cost principle, and in its article, the committee recommends that companies issue general price-level-adjusted supplementary statements.[60] In September 1975, the Committee published a more detailed Exposure Draft Study, entitled, "Proposal for Restatement of Financial Statements for Changes in the general price level" whose terms follow the American and British Precedents in all important respects. Comments on this Draft were due by December 1976.

In the Netherlands, an Exposure Draft entitled "Considerations on the act of annual accounts, part 3, chapter iva. 1: Methods for the determination of results" was issued by the Tripartite Committee of the Nederlands Institut Van Registeraccountants, Federation of Enterprises and Trade Unions. Comments on the Draft were due by December 31, 1975. The Philips Electrical Industries, whose headquaters is in Eindhoven, Holland, has been applying a replacement cost-accounting system for the last 40 years. The details of the application are given in the next chapter of this thesis.

South American states have also made some contributions on the subject of inflation accounting. Inflation has been endemic in this continent. Following ten years of severe inflation

in Argentina, the Argentinian accounting profession began a determined compaign in 1965 to gain acceptance of General Price-Level accounting.[61] In 1965, the Bolsa de Comercio de Buenos Aires (i.e. Buenos Aires Stock Exchange) offered to sponsor a major study on the most appropriate means by which to adapt financial statements to inflationary conditions. Not much support was gained from the Government for this study. In Chile, where annual rates of inflation during 1973 and 1974 were 508% and 376% respectively, the Government has recently acted. In May 1974, the Chilean accountancy body approved an accounting bulletin which called for supplementary financial statements in the style of the proposal in APB Statement No. 3. In December 1974, Chile, according to Stephen Zeff,[61] became the first country in the world to require comphrehensive inflation accounting, using a general price index, for income tax purposes. Inventories must be stated on current-replacement cost basis, the annual increment therein being subject to tax.

Black Africa has made no attempt to study the effects of inflation in company accounts. South Africa, which is still colonized, issued a Discussion Paper in January 1975, recommending replacement cost accounting. Comments on the Paper were due on May 23, 1975. What came out of the Paper is not yet known to the author. Most of the Black African Countries have not set up institutes of accounting which, in collaboration with governments, can undertake major studies such as inflation accounting. Kenya is in the process of setting up its own Institute of Certified Public Accountants, and we would hope that

this Institute will start to undertake a study of local accounting problems as soon as it is formed. Some of those local problems include the discussion on inflation accounting and the minimum disclosure requirements to the extent allowable by the local environment.

APPENDIX

Financial Statements Converted To Take Account of Price-Level Changes

The aim of this Appendix is to illustrate how a general price index can be used in adjusting financial statements. This appendix is divided into three parts:

3 - A) Tables of Kenya Consumer Price Indices

3 - B) Price Level Accounting--- an Illustrative Example

3 - C) Comments on the results of the Illustrative Example.

3 - A) Kenya Consumer Price Indices

The Kenya Government's Statistical Division of the Ministry of Finance and Economic Planning - the Central Bureau of Statistics - is responsible for collecting statistical data on price changes and then for preparing the price indices. These indices are prepared monthly and are published in the Kenya Statistical Digest, which appears quarterly, and in an annual Statistical Abstract. These two publications are obtainable from the Government Printer, Haile Selassie Avenue, Nairobi. Before 1969, the cost-of-living indices were prepared for the lower and middle income earners only. The indices were reviewed in 1969 when the Statistical Division of the Ministry of Finance and Planning started to prepare cost-of-living indices for three categories of income earners, namely:

(1) Lower (or Wage Earners) Group. This group include consumers who earn under 400/- per month.

(2) Middle Income Group which include earners of 400/- and above but less than 1400/- per month.

(3) Upper Income Group - those earning over 1400/- per month.

In view of the recent high rate of inflation, the present price indices need to be revised again so as to be more representative of the currently prevailing situation. Salaries and wages have more than doubled in the last decade. Minimum wages have been raised, and the current social classification of people (i.e. classification of people according to their earned income) is not suitable. There are few people earning less than 400/- per month in modern Kenyan companies. A greater variety of goods have been introduced into the market, while some others have disappeared. The above factors, with others, reflect the changes in expenditure patterns which have rendered the current weighting system less useful.

The following are the selected statistical tables which the author compiled using data from the monthly consumer price indices provided by the Central Bureau of Statistics:

T A B L E I

Quarterly Statistical Price Indices: August 1971 - December 1976

Base: August '77 = 100

		1971	1972	1973	1974	1975	1976
1st QUARTER	L		101.4	104.2	123.6	148.1	173.8
	M		101.6	105.9	122.0	142.9	164.5
	U		100.4	105.9	124.9	139.9	165.2
	Aver		101.1	103.5	123.5	143.6	167.8
2nd QUARTER	L		102.4	107.6	130.0	156.3	178.4
	M		102.5	108.2	126.6	151.7	168.5
	U		101.8	108.5	126.5	147.7	174.1
	Aver		102.2	108.1	127.7	151.8	174.0
3rd QUARTER	L	100.2	102.7	115.9	135.8	149.9	181.2
	M	100.2	103.4	114.5	130.8	155.0	170.0
	U	100.0	103.1	115.3	132.3	152.6	176.7
	Aver	101.1	103.1	115.2	133.0	152.6	176.0
4th QUARTER	L	100.4	103.6	119.4	138.8	165.3	182.2
	M	100.6	104.7	118.0	134.0	158.1	171.0
	U	99.7	104.2	120.5	134.5	156.7	178.8
	Aver	100.2	104.1	119.3	135.8	160.0	177.3

Source: The Central Bureau of Statistics, Ministry of Finance and Economic Planning.

Notes: The above initials, L, M, U, and Aver; represent the following:

L = Lower Income Price Index

M = Middle Income Price Index

U = Upper Income Price Index

Aver= Average Price Index (per quarter) for the three price indices (L, M, and U).

The first quarter starts in January and ends in March. The fourth quarter ends in December.

T A B L E 2.

Average Price Indices for June & December of Each year (1971 through 1976).

YEAR	JUNE	DECEMBER
1971		100.5
1972	102.5	104.4
1973	109.6	119.6
1974	129.4	136.2
1975	153.4	161.8
1976	174.8	177.6

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Source: Central Statistical Bureau, Ministry of Finance and Economic Planning.

Note: Average Price Index (in this context) = Sum of Price Indices for Lower, Middle, and Upper Income earners divided by 3.

3 - B. Price-Level Accounting: An Illustrative Example

In Section 1 of this chapter, we saw that there are five steps in the 'conversion process' of preparing adjusted financial statements when using a general price index. The five steps are summarized below:

Step 1 Stabilize the balance sheet at the start of the year. Convert accounts into current purchasing power units relating to the beginning of the year.

Step 2 Calculate the loss (or gain) on being a net lender (or borrower).

Step 3 Prepare the stabilized income statement

Step 4 Stabilize the beginning balance sheet in shillings as at the end of the current year. This is done by 'rolling forward' the stabilized balance sheet in step 1.

Step 5 Stabilize the balance sheet at the end of the current year (stating the units in shillings of that date).

Below is an illustrative example of stabilization process. Steps 4 and 5 are presented together.

Example

Kimbo Company Limited commenced its business in 1971. The following is its balance sheets at 31 December, 1974 and 1975, and profit and loss account for the year ended December, 31, 1975.

Conventional Balance Sheets at 31 December (in K Shs.)

	1974	1975		1974	1975
Land & Buildings	210,000	210,000	Share Capital	200,000	200,000
Stock	150,000	180,000	Profit and Loss account	175,000	215,000
Debtors	75,000	90,000	Debentures	50,000	50,000
Cash	90,000	60,000	Creditors	100,000	75,000
	525,000	540,000		524,000	540,000

Profit and Loss Account, 1975

			KShs.
Sales			800,000
Less:	Cost of sales	580,000	
	Selling and Admin.	157,500	
	Debenture interest	4,000	741,500
			58,500
Less:	Dividends paid		18,500
	Undistributed Profits		40,000

Other Relevant Information

1. The following general price indices prevailed:

Period	index
January 1, 1972	100.0
January 1, 1973	105.0
January 1, 1974	119.0
January 1, 1975	135.0
June 30, 1975	153.0
December 31, 1975	162.0

2. Land & buildings were acquired on 31 December, 1971. All the share capital was issued at the same time (Dec. 31 1971).

3. The debentures were issued at the end of 1974 (when the index = 135).

For simplicity, interest on debentures is assumed to accrue on July 1.

4. The sales, and selling & administrative expenses accrued evenly during 1975.

5. The dividend was paid on 31 December, 1975.

6. The Kimbo Company uses the FIFO stock flow convention. The stock on hand at the end of 1974 was acquired when the price index was 135. Purchases during 1975 were KShs. 390,000 when the index was 153 and KShs. 220,000 when the index was 162.

Conversion Process:: The following is the stabilization based on the figures given in the financial statements and the additional information.

Step 1. Balance Sheet at 1 Jan. 1975 (stated in Shs. of that date).

	Shs.
Land & Building ($210{,}000 \times \frac{135}{100}$)	283,500
Stock	150,000
Debtors	75,000
Cash	90,000
	598,500
Share Capital ($200{,}000 \times \frac{135}{100}$)	270,000
Debentures	50,000
Creditors	100,000
Profit and Loss (stabilized)	178,500
	598,500

Step 2. Calculation of Loss on holding money

Loss on net money at start:

$(75{,}000 + 90{,}000) - (50{,}000 + 100{,}000) = 15{,}000 \times \frac{27^*}{135} = 3{,}000$

Add: Sales	800,000	
Less: Selling & Admin. Exp.	157,500	
	642,500	
Less Debenture Interest	4,000	
	$638{,}500 \times \frac{9^{**}}{153}$	=37,600
		40,600
Less: Gain on Purchases	$390{,}000 \times \frac{9}{153}$	=22,900
Loss on Holding Money		=17,700

Notes * 162 - 135 = 27: ** 162 - 153 = 9

Step 3. Income Statement for the Year 1975

(stated in shillings as at 31 December 1975)

Sales	800,000 x $\frac{162}{153}$		Shs. 847,000
Less: Cost of Sales:			
Beginning Stock	150,000 x $\frac{162}{135}$ ...	Shs. 180,000	
June 30 Purchases	390,000 x $\frac{162}{153}$ ...	413,000	
December 31 Purchases	40,000 x $\frac{162}{162}$ ...	40,000	
		633,000	
Selling & Admin. Expenses	157,000 x $\frac{162}{153}$....	166,300	
Debenture Interest	4,000 x $\frac{162}{153}$....	4,300	803,600
Stabilized Income, December 31, 1975..... ..			43,400
Less: Loss on holding money (see step 2)			17,700
			26,700
Less: Dividend Paid.....			18,500
			7,200
Add: Balance as at start (stabilized)	178,500 x $\frac{162}{135}$		214,000
Undistributed Profits, December 31, 1975			221,200

Step 4 & 5 Stabilizing Beginning & Ending Balance Sheets

(stated in shillings of December 31, 1975)

	1975		1974
Land & building ($210{,}000 \times \frac{162}{100}$)	340,200	.. $283{,}500 \times \frac{162}{135}$ ..	340,200
Stock.....	180,000	.. $150{,}000 \times \frac{162}{135}$ ..	180,000
Debtors.....	90,000	.....	75,000
Cash.....	60,000	.....	90,000
	670,200		685,200
Share Capital ($200{,}000 \times \frac{162}{100}$)	324,000	.. $270{,}000 \times \frac{162}{135}$ ..	324,000
Profit and Loss a/c	221,200	..P&L (stabilized)	236,200
Debentures.....	50,000	.....	50,000
Creditors	75,000	.....	75,000
	670,200		685,200

3 - C Comments.

The above five steps provide a comprehensive conversion process for the adjustment of historical cost statements. The two stabilized balance sheets at start and the end of 1975 can now be compared in equal terms because both are stated in the same units of purchasing power as at 31 December, 1975.

Observed effects of stabilization

1. The value of non-monetary assets is higher when stated in stabilized figures than when stated in historical cost figures.

(cf. land & building; historical cost = Shs. 210,000; stabilized value = Shs. 340,200)

Note that this characteristic holds during inflation. The reverse may occur during deflation.

2. Monetary aasets are stated in same money figures in both the historic and stabilized financial statements.

3. Undistributed profits figure decreased greatly when the financial statements were stabilized. The conventional accounting profit (in December 31, 1975 purchasing power units) is Shs. 7,200. This reveals the fact that conventional financial statements tend to overstate profits during inflation, this leading to higher taxation based on the conventional accounts profits.

4. Stabilization of financial statements make the accounts of various years more comparable by stating the units in the accounts in same purchasing power terms.

5. The dividends-paid figure remained the same in both historical and stabilized financial statements because the dividends are assumed to have been paid when the price index was 162.0

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48. "Reporting the Financial Effects of Price-level Changes", Accounting Research Study No. 6, by the Accounting Institute of Certified Public Accountants (AICPA) 1963 p. 1.

49. Frank T. Weston, "Adjust Your Accounting for Inflation", Harvard Business Review, January-February, 1975 p. 23.

50. See the Discussion under Committees in U.K. and Scotland, "above".

51. Paul Rosenfield, "GPP Accounting - relevance and Interpretability" p. 56 Journal of Accountancy, August 75).

52. Mathews Report, Report of Committee of Inquiry into Inflation and Taxation.
Australian Government Publishing Service, May 1975.

53. D.R. Rickard, "Current Cost Accountancy" The Australian Accountant, May 1976, p.194.

54. D.R. Rickard, op. cit., p. 194.

55. Rex. Thiele, "Accounting for the Effects of Inflation" The Australian Accountant, May 1976, pp. 201 - 202.

56. E.M. Sandish, op. cit., p. 637-641.

57. D.R. Rickard, op. cit., p. 194

58. J.R. Edwards, "Inflation Accounting: The best of Both Worlds" The Accountant, January 15, 1976. The "Publication in Different

Countries on the Accounting Treatment of Changing Prices" by 10th. October, 1975 are listed under the Appendix to the Chapter referred to in this reference. See also reference No.60 below.

59. Harry G. Schaefer: "CVA - An Acceptable Alternative?" CA Magazine, October 1976, p.21.

60. Stephen A. Zeff: "Impact of Inflation on Accounting: A Review of the Response of the Accounting Profession in 10 Countries" Management Decision, Vol.14, No.3, 1976 , p.111.

61. Stephen A. Zeff: op. cit., p. 113

62. A company can use price quotations provided by suppliers on request to revalue its assets. A price quotation on, say, a new machine can be depreciated to arrive at the 'current value' of a similar second - hand machine held by the company by using the expired time since the machine was first acquired. Such 'current values', if worked out annually, can enable a company to develop specific price indices of each asset or a group of assets held by the company. This method is being used by some of the Kenyan companies which re-value their assets periodically. If a company fails to get price quotations of some assets, it can use the consumer middle income index which is available from the Central Bureau of Statistics, Ministry of Finance and Economic Planning.

The Kenya Government also prepares specific price indices, particularly for building materials. A Construction Cost Index is computed on the basis of estimates of changes in the costs of each input (or constituent).

C H A P T E R F O U R

FINANCIAL REPORTING BY COMPANIES IN KENYA

4-1A Introduction

A research survey was carried on accounting practices by companies in Kenya. It covered parastatal bodies, public companies, and private companies. . . . Emphasis was laid on capital intensive companies (i.e. companies with a greater proportion of capital to labour) which experience a great impact of changes in prices. These companies import most of their machinery and mainly from Western Europe, where inflation has been remarkably high. The companies, therefore, continue to import machinery at inflated prices, thereby experiencing an imported inflation. Most of them happen to be manufacturing companies whose fixed assets last for a long time before they are disposed of as unuseful assets.

This chapter gives a summary of the outcomes of the research. The summary covers views of financial managers of the surveyed companies and also the financial reporting systems in practice.

4-1B Purpose of the Research.

The research was carried out in local companies so as to gain knowledge on the following:-

a) the systems of accounting being practised by the companies;

b) the extent to which inflationary effects have been reflected in the accounting statements;

c) the responses of local companies to the international discussions on inflation accounting;

d) any efforts being made towards improving local financial reporting.

In addition to the above objectives of the research, the author

was interested in finding a basis of recommending further improvements in the local financial reporting. The author also wanted to bring to the attention of local financial managers that the University of Nairobi is encouraging greater research on inflation accounting.

4-1C Selection Methodology of Surveyed Companies

The author selected seventy companies on a more or less random basis. The companies were chosen on the belief that:

a) they were practising inflation accounting to some extent; or

b) they were large enough to be able to prepare inflation accounting statements (on the basis of financial ability); or

c) they had business connections or associations with parent companies located in Western Europe, Canada, U.S.A. or in Australia where discussion on infation accounting has reached advanced stages (the accounting practises of parent companies are likely to be extended to subsidiary companies); or

d) they were likely to respond positively to the author's questionnaires.

In addition to the above selection, the author selected a few parastatal bodies in order to compare their accounting systems with those of the commercial firms.

The surveyed companies are classified into two categories, namely:-

1. Companies which are quoted on Nairobi Stock Exchange, and

2. Companies which are not quoted on Nairobi Stock Exchange.

The two classes of companies are referred to as "quoted companies" and "non - quoted companies" respectively in the following analysis. Quoted companies were half of all the surveyed companies while the

other half was made up of non-quoted companies. A quarter of non-quoted companies were the parastatal bodies.

The quoted companies are required by law to publish their financial statements. These statements are, therefore, accessible to the public (or external readers).

Out of 24 companies which returned the writer's questionnaires duly completed, there were 13 quoted companies, 8 private companies and 3 parastatal bodies. In analyzing responses from these companies, the writer has considered both private companies and parastatal bodies under the class of 'non-quoted' companies. We shall therefore have 13 quoted companies and 11 non-quoted companies.

The survey revealed that foreign subsidiaries are keen in updating their accounts. This is true as we shall see later because directives are issued by parent companies to the effect that inflation accounts must be prepared and then sent to those parent companies. Our local companies have also started to develop some interest on revaluing some assets in the wake of the high inflation of recent years, and also because of the great debate on inflation accounting in the developed nations. The following table shows the coverage of my survey with regard to interviewing financial managers and the mailing-out of the questionnaires.

Table 4.1 SUMMARY OF SURVEY COVERAGE

	Number
1. Companies which received questionnaires and were also interviewed	10
2. Companies which were interviewed but did not return the questionnaires they had received	4
3. Companies which received questionnaires but gave negative responses*	8
4. Companies which were sent questionnaires but from whom no responses were received	24
5. Companies which received questionnaires and returned them duly completed	24
6. Total number of companies to which questionnaires were sent.	70

* Negative responses refer to either:

(a) uncompleted questionnaires which were returned by companies or

(b) written regrets expressing companies' inability in completing the questionnaire.

The table clearly reveals that the responses were fairly good. Some questionnaires did not probably reach the right persons, and therefore, were not returned. The reason for this failure is partly because of the problem of not knowing precisely to whom they should have been addressed. Some companies do not have company secretaries, while others do not have chief accountants. Letters addressed to any one of such persons undoubtedly ended up becoming lost because messengers fail to know to whom to give those letters. Presumably some managers failed to answer the questionnaire because they had no time to do so or because the questionnaire was rather technical and academic.

Among the negative responses received, some managers gave different excuses, such as the ones quoted below:

* I regret I have not been able to send you your questionnaire on "Inflation Accounting" as I have been very busy.
* I regret I shall not be able to see you as I shall be away on leave with effect from tomorrow.
* The questionnaire is not applicable to our type of business.
* I am not in a position to complete your questionnaire.
* We are not in a position to assist you as requested.
* We regret that we are not in a position to supply you with the information (requested for) or arrange for a meeting as the Company is being sold.

* Our Chief Accountant is at present on leave and will resume duty towards the end of.....

* We are therefore not in a position to attend to this matter at present. (Note that this firm did not respond thereafter up to date - about five months past).

As the above responses show, the writer had requested the firms to allow him to visit them in addition to having sent them the questionnaire. The writer carried out personal interviews with some managers whose views are presented below.

Among those interviewed was Mr. Denis, the head of the Accounting Services in the Kenya Government. He expressed his concern over the effects of inflation, and stated that the Government experiences the effects of inflation just as any company which buys both locally produced goods and imported goods. He commented that our local inflation is an 'imported' inflation because we import goods from **Western Europe and North America where inflation is worse than here in Kenya.**

4 - 2 VIEWS OF FINANCIAL MANAGERS

The survey came out with mixed views as to whether we should retain the conventional accounting system, or whether we should adopt another system of reporting to show clearly the effects of inflation.

(i) ARGUMENTS IN FAVOUR OF THE CONVENTIONAL ACCOUNTING SYSTEM

Some financial managers who argued in favour of historical-cost accounting stated that it is not misleading at all so long as the users of the financial statements understand it. Any change or modification of the system may give room for manipulation of accounts, and hence, less appropriate custodianship of the shareholder's capital. The managers argued that there is no agreement on any one best alternative to historical cost accounting, and this reflects the general view that the historical cost system is still the best. The historical accounting system is objective and simple, and therefore more understandable and less biased. It can be understood by both laymen and the intellectuals. One company asserted that if the external users, e.g. creditors, need current values of assets, they can ask for them and will be given the information. (Note that this view falsely assumed that each company knows or prepares current values to give to those who need them). Historical cost accounting is not misleading for short run decisions, but might be misleading for long term decisions. This also depends on the nature of the decisions and the intelligence of the decision makers. Information provided by the conventional accounts is not misleading so long as the users understand the basis of its preparation and so long as we do not experience high inflation. (This view assumes that we have not experienced high inflation that can force us to think about alternatives to historical cost accounting).

During inflation the information provided by the conventional accounts may not be misleading so long as the shareholders are

aware of the inflation; they should be aware that Shs. 20/- last year is not the same as Shs. 20/- this year, given price-level changes. (This view assumes incorrectly that all shareholders understand the difference in values between the two Shs. 20/-).

On the question of setting aside funds for replacement, one manager retorted: "Setting aside funds for replacement is not a problem. You need an accurate estimate of the replacement cost of the asset to replace the existing asset. After determining this replacement cost, you can then start setting aside funds to achieve the target. Given that there are sufficient funds, there is no problem of achieving the target. This is particularly so if the accumulated depreciation is backed by cash."

(ii) THOSE MANAGERS WHO CRITICISE CONVENTIONAL ACCOUNTING BUT HAVE NO ALTERNATIVE TO ITS USE

There are financial managers who would favour modification of conventional financial statements, but have no option and have to continue with the historical cost accounting. These managers have no suitable measure of inflation. Some stated that since the debate on inflation accounting is still continuing, they have to wait until a general consensus is reached on one best alternative system. Their firms will then follow suit.

Some managers expressed the view that it will take a long time before relevant accounting for price level changes takes place in Kenya. One chief accountant stated that 'the introduction of Inflation Accounting will create more problems, taking into account the fact that accountants cannot even

prepare good financial statements based on the historical cost system.' The accountant said that in theory, inflation accounts should be prepared. However, he stated that in practice, inflation accounting would probably lead to confusion. He also stated, "We do not believe inflation accounting will generally be understood or accepted in Kenya for some years to come." The same view was expressed by many other financial managers. They asserted that, since developed nations like the United Kingdom and the United States have not agreed to implement any one system of inflation accounting, it will take some decades before inflation accounting is fully accepted in Kenya. Even the head of Accounting Service in the Kenya Government, Mr. Denis, expressed doubt that inflation accounting will be accepted and implemented in Kenya in the near future. He indicated that he had been following closely the debate on inflation accounting and had concluded that inflation accounting may be accepted in theory but may take many years to be implemented, even in developed nations. He felt that, in Kenya, the progress on such matters as inflation accounting may not advance quickly because we do not have an accounting body which can carry out studies on such problems and issue reports to the Government. Mr. Denis added: "The accounting body is going to be created soon. As soon as the body is formed, we shall throw many of the accounting problems to it, hoping that it will give us solutions to those problems."

Some accountants expressed their fear that inflation accounting might be too expensive to implement, let alone the problem of its being accepted. They stated that before inflation

accounting is implemented, the managing directors of firms must be convinced of the justification of the additional costs to be incurred. They also stated that inflation accounting would call for re-education of managing directors, the shareholders and creditors. They added that inflation accounting will create more problems of understanding to shareholders, since most shareholders do not even understand the historical cost accounts well.

4-3 COMPANY FINANCIAL REPORTING IN PRACTICE

The corporate reports of the companies in Kenya may be divided into two categories:

(a) Corporate Reports which are based on historical cost accounting.

(b) Corporate Reports prepared on the historic cost basis, but supplemented with inflation accounting statements.

Category (a) refers to firms which have not yet made any attempt to implement inflation accounting, while category (b) refers to firms which prepare inflation accounts in addition to historical cost accounts. We shall discuss each category separately.

When we refer to 'corporate reports,' most people think of 'public accounts'. They may be correct. In this survey my concern was not only with public reports, but also on management reports (or reports produced for internal purposes only). Financial statements are important not only to internal management

but also to the external users. A number of companies have started to prepare supplementary inflation accounts to their conventional accounts so as to aid their management in decision making.

(A) REPORTING BASED MAINLY ON CONVENTIONAL ACCOUNTING SYSTEM

Most of the companies in Kenya prepare conventional accounts without supplementing them with, say, inflation accounts or supporting schedules which give the current data on operations. In my survey, 50%* of the companies surveyed indicated that adjustments are made in their accounts (see Qu. 5 of section 4-4 below). This percentage is, however, exaggerated because some of these companies have made only one or two revaluations of some of their fixed assets - mainly land, and plant and machinery. It is interesting to note that only 8%** of the surveyed quoted (or public) companies indicated that they make adjustments in their accounts in order to reflect the impact of inflation (see Qu. 5 Section 4-4). Some companies stated that they cannot change their policies before they are authorized to do so by their head-offices. This applies to both local subsidiaries and foreign subsidiaries. This should not, however, lead to a wrong conclusion that all subsidiary companies in Kenya do not adjust their accounts. Quite a number do adjust them, mainly the foreign subsidiaries whose parent companies are in the United Kingdom, United States, Netherlands or Australia. The East Africa Industries and Dunlop Companies are among those which adjust their accounts, and their parent companies are in the United Kingdom.

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* The 50% of the companies represents 12 companies out of 24 companies which responded.

** 8% represents one company out of the 13 quoted companies which responded.

There are some companies which stated that plans are underway to adjust their accounts, but they did not specify how long it will take before they begin to make such adjustments. Block Hotels Limited, whose name was changed to Kulia Investment Limited as from November, 1975, is among those firms which intend to make adjustments in the near future. Consolidated Holdings Limited started to prepare inflation accounts in line with the Sandilands Recommendations at the end of 1976.

Hutchings Biemer Limited, which sells and leases furniture, stated that it has not yet thought of making any adjustment. In my discussion with its Chief Accountant, I learned that the company raises list prices periodically, but the accounts figures remain at historical costs. One company gave the view that it cannot start adjusting the accounts before the Sandiland Report is accepted. One financial manager stated that if adjustments for inflation are allowed, this may lead to a "larger element of profit being put to reserves." He argued incorrectly that "this will be a new departure from the accepted standards of accounting."

Some of the companies in this category* do make periodic revaluation on a piece-meal basis to some of their fixed assets. Of the total companies surveyed, 33% of them had revalued both their building and plant, (see Responses to Question 9 of Section 4-4 below). These percentages may not be reliably representative because the total response to my questionnaire was fairly good. The percentage for those firms which have revalued buildings is small because some of the firms

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* i.e. Companies which base financial data on historical-costs.

stated that they own no buildings, and they carry out their business in leased buildings. For this reason, they do not have buildings to revalue.

A good number of the surveyed firms indicated that they report their fixed assets at both 'cost'and 'valuation'. The following examples are taken from the balance sheets of Brook Bond Liebig (K) Ltd. and Marshals (E.A.) Ltd. The examples 4-1 and 4-2 respectively may reflect the manner in which the local companies prepare their accounts.

Example 4-1 BROOKE BOND LIEBIG (K) LTD.

A SECTION OF THE NOTES TO BALANCE SHEET AT JUNE 30, 1976

Fixed Assets	Land and Development	Buildings	Plant & equipment	Total
	K£	K£	K£	K£
Valuation and Cost:				
Valuation				
1969.....	5,300	-	-	5,300
1974.....	220,610	58,500	-	279,112
1975.....	7,718,600	6,903,500	-	14,622,100
1976.....	1,295,357	283,500	-	1,578,857
Cost	54,805	463,674	2,915,929	3,434,408
	9,294,674	7,090,174	2,915,929	19,919,777
Less: Accumulated Depreciation	2,303	5,269	1,803,212	1,810,784
Net Book Value at June 30, 1976	9,292,371	7,703,905	1,112,717	18,108,993

In addition to the above illustration, the company also prepares movements of fixed assets during the year. Under this, valuation, additions and disposals during the year are shown. The 'Surplus on Revaluation' is also shown separately. All these details are given in notes to financial statements.

As the above example show, Brooke Bond Liebig does revalue its fixed assets at periodic intervals to reflect the effects of price changes on fixed assets. This is actually a partial move to **inflation** accounting.

Example 4-2

MARSHALS (E.A.) LIMITED

PART OF NOTES TO BALANCE SHEET, DECEMBER 31, 1975

Fixed Assets	Free-hold land & building	L. Term lease-hold land & building	S. Term lease-hold land & building	Plant and Equipment	Total
31st Dec.,					
1974.....	72928	738377	188623	414006	1413934
Additions	24600	82393	2310	62329	171631
	K£	K£	K£	K£	K£
Transfers/					
Disposals	(5919)	5919	-	(22003)	(22003)
31st Dec.,					
1975.....	91,609	8,26689	190333	454331	1563562
	91,609	281689	80933	454331	908562
Valuation					
1969	-	55000	-	-	55000
1973	-	490000	110,000	-	600,000
	91609	826689	190,933	454,331	1563562

The above example reveals that Marshals (E.A.) Ltd. revalues its fixed assets periodically every 4 years. This has been a common practice in many manufacturing companies whose long-term assets show very low historical book values compared to their current values. The excess of the appraised values over historical costs is disclosed under 'Reserves' account, and is termed 'Surplus on Revaluation' or 'Revaluation Reserve' or 'Capital Reserve'.

Revaluation tends to reduce the mix of different values of money stated as 'cost of fixed assets.' It tends to state different money values in approximately the same money values as far as purchasing power is concerned. If all fixed assets were revalued at the end of each accounting year (thus approaching current value accounting), we would not have the aggregation problem of mixing different unit-values of money.

Referring to responses to Question 8 of Section 4-4 below, 17 out of 24 firms reported that their depreciation is based on historical cost. In the case of quoted companies, 77% of them stated that they still depreciate their fixed assets on the historical cost basis. For the firms which depreciate a 'pooled cost' of their fixed assets, the depreciation may be on both historical cost and appraisal value if pericdic revaluation takes place.

The firms which revalue their assets periodically tend to base their valuation on a professional valuer's advice. 9 out of 24 firms which were surveyed indicated that they u use valuers reports, (see Question 10 of Section 4-4). About 10% of those firms used both valuers' report and specific

price indices to revalue their assets.

Many firms report their stock at lower-of-cost or net realizable value. The term 'cost' means different things to different firms, depending on the nature of the stock. It also depends on the basis of valuation: whether first-in-first-out (F.I.F.O.), last-in-first-out (L.I.F.O.), specific identification, weighted average or other basis. Referring to responses to Qu. 20 in Section 4-4 below, about 8% of the surveyed firms use LIFO, 17% use FIFO, 13% use specific identification, 38% use weighted average, and 13% use other methods. Among the quoted companies that were visited by the author, none of them use LIFO in valuing their end-year stock. Many of them use FIFO.

None of the firms surveyed has attempted to calculate a gain or loss on cash and other monetary assets. These items are stated at their historical costs (or historical moneys). The values of receivables and liabilities are fixed by contract, and some firms stated that there is no likelihood that firms will begin to calculate the gain/loss on monetary items in the near future. E.A. Railways stated that "cash is held at current prices, and so there is no need to calculate a loss on holding it." The Consolidated Holdings Limited, whose principal subsidiaries include the Printing and Packaging Corporation Ltd, East Africa Standard (Newspapers) Ltd, and Stationary and Office Supplies Ltd, stated that it is very difficult to quantify the cost of stock consumed during the year, and the cost of holding cash or other monetary assets. In theory, however, most firms agreed that the cost of holding stock, the cost of holding cash, and the gain on equity

from borrowing should be reflected in the accounts. Over 75% of the surveyed firms indicated that it is necessary to reflect the effect of inflation on the cost of holding stock to be consumed during the year, on fixed assets, and on the depreciation of fixed assets. (see Qu. 3.)

Many firms expressed the view that if inflation accounting is adopted, it should cover all areas - i.e. the "all-inclusive" principle of inflation accounting. In other words, inflation accounting should be reflected on all items of the financial statements including revenues and expenses. Brooke Bond Liebig is one of the proponents of this view.

Answering the question on the effect of inflation accounting to financial users, many firms agreed that the financial statement users will definitely benefit from such a move. According to responses to Qu. 4 in section 4-4 below, over 75% of the surveyed firms' indicated that inflation accounting would result in better decisions made by financial statements users. About 29% of the firms stated that inflation accounting would confuse the financial statement users. Some firms indicated that inflation accounting would lead to both better decision making and also to confusion because inflation accounts are likely to be more complicated. The firms which expressed such a view include Grindlays Bank International, which stated that the information presented by inflation accounts will give a current picture instead of the historical picture of the affairs of a company. The bank stated in addition that the inflation accounts will also be "confusing as the readers will not be accustomed to them." Philips, Harrisons and Crossfield Co. Ltd. stated that inflation accounts

will give both good results and confusing information. Also, the cost of producing the more sophisticated figures as well as historic figures may well prove to be too time consuming and expensive.

Most firms contacted indicated that they do not have a policy for setting aside funds for replacement. Many of them stated that funds are set aside as the decisions to purchase or to replace are made. Such a view was expressed by the Coffee Board of Kenya, which reported that it does not set aside funds in advance but waits until the decision to replace has been made.

When this decision is reached, the payments to coffee growers are reduced accordingly to enable the board to purchase the required assets. This view is held because the board has never run short of funds, otherwise experience might have been the best teacher. The same view was expressed by the Mobil Oil Company, although it also stated that its replacement policy is incorporated in its budgets.

Under replacement cost accounting, smaller profits are reported than under historical-cost accounting during periods of inflation. The reporting of lower profits means that more funds are reserved through higher depreciation based on the current values of assets. Firms should in addition have a specific replacement policy which ensures that there will be cash when needed. The inflationary supplement should be incorporated in such a policy.

Company officers responsible for budgeting have to convince their board of directors that the inflationary supplement

to be incorporated is sufficient and yet not excessive. The efficiency of budgeting depends on past experience. Some of the surveyed firms stated that expected price increases are incorporated on the basis of past experience and the expected trend of events. The budget figures are "inflated" by a certain determined percentage. Quite a number of firms said that they use an average factor of 10% to inflate the budget. Consolidated Holdings Limited uses an inflationary factor of about 15% to inflate its budgets. The chief accountant of East Africa Industries agreed that an inflationary factor should be incorporated in budgets especially when it comes to projecting the future. In the case of raw materials, the chief accountant stated that since the company buys raw materials in the world market, the officers in charge of budgeting must make an assessment of the market prices on the basis of both past trends and the expected trends of those prices. This forces the officers to be constantly in touch with the world market. The Unga Company Ltd. said that it inflates wages by an average factor of 10% to take account of inflation. "Factors for other costs will vary with the items involved," the company secretary of Unga Company said. The necessary inflationary factor on these items is difficult to determine with reasonable accuracy. Problems are created by the uncertainties of the market trends of prices, the unpredictable states of market demand and supply, and estimates of future negotiation strengths between the company and suppliers.

No local company has attempted to show the inflationary effects on annual revenues and the expenses incurred to produce those revenues. The profit and loss account is purely in

conventional accounting terms. Some companies alleged that these revenues and expenses are stated in current terms and that, therefore, they do not require any adjustment. Their Profit and Loss Accounts are prepared on the conventional basis, and their formats look like this:

	K£
Profit before taxation	xx
Less: Taxation	x
Profit after taxation	xx
Dividends	x
Undistributed Profit	x

All the figures in the profit and loss account are stated in historic cost terms. The most likely result is that the costs are understated. And yet, one finds the firms stating that they made extremely high profits, when probably they could have had realized losses if all the revenues and costs were stated in constant money terms. For example, the Director of Bamburi Portland Cement Company stated in its 1975 annual report: "The Company has again achieved improved results and the pre-tax profit at £x... has increased by 75% over the figure for 1974 owing chiefly to higher earnings on exports." The director, however, failed to consider the understated expenses which were netted against the revenues. In an interview with one of the accountants of the company, it was learned that depreciation is

still being based on historical cost of an old factory. A new factory was being erected, and it is expected to cost more than twice the cost of the old factory. The funds accumulated indirectly through depreciation were not sufficient to cover even a third of the new factory's cost. This means that the company may soon experience a replacement problem if it does not set up a replacement policy which allows for inflation, or if it does not start adjusting its accounts for inflation. In the same 1975 published report of Bamburi Portland Cement Company, the Chairman of the Board of Directors struck the point when he stated; "From the Director's Report you will note that last year's statements forecasting improved results for 1975 were too optimistic. One should not forget, however, the inflationary factor underlying such figures. The combined replacement value of the factory's old and new plant is about three times their book value....."[1] This tends to support my assertion that Bamburi Portland Cement Company may experience financial problems unless it establishes a policy of setting aside funds for replacement.

(B) COMPANIES WHICH PREPARE SUPPLEMENTARY INFLATION ACCOUNTS

At the start of the survey on this topic (i.e. inflation accounting), there was a misconception that no companies operating in Kenya prepares inflation accounts. The survey has, however, revealed that some companies do prepare those accounts. Among these companies are East Africa Industries, Dunlop Company Limited, and Philip (Kenya) Company Limited. Readers will notice that these companies are foreign subsidiaries. Both Dunlop

Company and East Africa Industries are English Companies. Philips (K) Ltd is a Dutch Company with its parent company in Holland. Consolidated Holdings Limited aimed at starting to prepare inflation accounts at the end of 1976 in line with the Sandilands Recommendations.

EAST AFRICA INDUSTRIES LIMITED

In an interview with the chief accountant of East Africa Industries Limited (E.A.I. LTD.) it was revealed that the company has been preparing inflation accounts for the last 15 years.

The adjustments are made by using both general price indices and specific price indices. The job of revaluation is done by Tysons Habenga Ltd - professional valuers and estate agents. The valuer's report is reconciled with management estimates. Specific indices, prepared by the industry, are used in revaluing most fixed assets. The consumer middle income index is used on most of the other fixed assets. Current assets are not affected by the revaluation process. The company follows more or less the Sandilands Recommendations. Professional valuers value the assets at two-year intervals. The plant has been revalued three times - 1969, 1971, and 1974. It was to be revalued again at their accounting year which ended December, 1976. The company prepares supplementary reports based on current values for internal use, (i.e. for use by management) in addition to historical financial statements. The historical financial statements are prepared for taxation purposes, since the capital-cost allowances

are based on the historical cost of fixed assets. The chief accountant agreed that the information supplied by historical-cost accounts is somewhat misleading because it is not based on current values. He agreed that depreciation is understated and profits are overstated by conventional accounting, particularly for capital intensive firms. This has led to higher taxes. He advocated future changes in tax laws to base the capital allowances on the revalued amounts of fixed assets. This, he said, may reduce the amount of tax paid and may result in greater retention of profits for expansion purposes. He was not in favour of the standard report issued by auditors. He said the statement that "..... the accounts set out on pages x and y.. give a true and fair view of the state of the company's affairs at 19x1", needs to be modified to include comments on items which have not been revalued yet require revaluation, and also to report other factors relating to current values of assets. The auditors' opinion was standardised when changes in prices were insignificant. Such standard wording does not mean much to, say, a capital-intensive company which does not revalue its assets even in the present inflationary times.

Commenting on the CPP accounting which was advocated by the Accounting Steering Committee of the U.K., the Chief Accountant was of the view that CPP accounting is no better than historical-cost accounting. He was in favour of the Sandilands Recommendations which, he said, need some few modifications in order to be perfect in their application. Some modifications to the Sandilands recommendations should be made in regard to the treatment of monetary items; the loss or gain on these items should

be disclosed separately. He said that his company will start preparing inflation accounts based on the Sandilands Report in 1978.

East Africa Industries values its stock by using the price quotations of those materials just before the balance sheet date. The quoted prices are used to determine the net realizable value of the stock, and this is then compared with the original cost of stock before establishing the new carrying value of the stock. The stock is then valued at the lower of cost or market (market in this case is represented by net realizable value) whichever is lower.

According to the Chief Accountant the daily, monthly, and half-yearly cashflow statements report on the funds available for replacement. "Looking at the funds flow, we can tell whether there are sufficient funds for replacement." This view is correct as long as the cashflow forecast is closely related to capital expenditures.

The chief accountant of E.A.I. concluded by stating that the aim of any firm is to survive. "The firm cannot survive if it has no sufficient funds for asset replacement and expansion. Historical-cost accounting does not aim at retaining sufficient funds for asset replacement and expansion. Current value accounting is the best method which can ensure sufficiency of the funds." He commended the latter system because it reports less profits during inflation, and this means that less dividends will be paid and more retentions made.

DUNLOP (KENYA) LIMITED, a subsidiary of Dunlop International in London, prepares inflation accounts for internal use by

management in addition to statutory accounts. It started preparing these inflation accounts two years ago. It began sending copies of these accounts to its parent company by the beginning of 1975. Both the historical cost financial statements and the inflation accounts are audited by the company's auditors.

In adjusting the historic costs of assets, the company uses specific adjustment rates which are prepared by U.K. Insurance Companies. These rates are sent to the Company quarterly. The adjustment of fixed assets and stock are now based on the Sandilands recommendations for fixed assets. U.K. Insurance Companies advise the Dunlop Company on the rates to use in adjusting its different assets.

Depreciation of Dunlop's fixed assets is based on the present-day value of the assets. The depreciation is more or less accelerated as the value of the assets continue to rise. On the issue of setting aside funds for asset replacement, the accountant of Dunlop Company said that, "..... any sensible business must maintain a policy of maintaining sufficient profit for replacement of assets." The Dunlop Company follows the following procedure in maintaining funds:

(1) Project the future expenditure on fixed assets.

(2) Project the amount of profits expected to be earned.

(3) Estimate the inflationary rates.

(4) Estimate the dividends to be paid in future.

From the above estimates, the company can work out the amount to

be set aside for replacement of fixed assets, and also for future expansion.

Monetary items are not adjusted for inflation, just as the Sandilands Report recommended.

Stock is valued on the normal F.I.F.O. basis. The Sandilands Report also suggested that for asset valuation purposes a normal F.I.F.O. stock valuation will broadly suffice as a "current cost valuation" provided that stock is turned over reasonably quickly and that the rate of change of price of stock is not excessively high.

Dunlop's profit and loss account includes 'additional depreciation on inflation revaluations' on fixed assets. It also includes 'deferred taxation inflation adjustments' and 'minority share of inflation adjustments (net of tax).'

Dunlop's accountant stated that it is quite necessary that firms with fixed assets lasting for more than five years revalue those assets periodically. "Failure to do this would result in understatement of depreciation on fixed assets, and hence overstatement of profits", the accountant added. Asked whether the company experiences problems in preparing inflation accounts based on current values, he replied that they experience no problems. "The exercise only adds extra work," he said. "It is relatively easy to get current market values." The accountant was, however, referring to valuation of imported assets on which the company gets quarterly price indices from U.K. Insurance Companies for the adjustment of those assets. Locally, it is not

easy to get the indices from the Kenyan Insurance Companies. These Insurance Companies do not compile such lists of price indices. Dunlop's accountant concluded by stating that inflation accounting is the sensible way of treating accounts; that this would lead to a true position of the company's current financial status, and that inflation accounts tend to give data for good future projections. On 6th February 1976, Dunlop International issued a circular to its subsidiaries directing them to prepare inflation accounts based on the Sandilands Report. The following is a summary of the cardinal points of the circular;[2]

(1) The circular was issued by The Treasurer in Dunlop International, London, to all of its Finance Directors and U.K. Accountants.

(2) The circular stated that the U.K. Government, Stock Exchange and the accounting bodies strongly supported the Sandilands proposals.

(3) The circular stated, "It is essential that Dunlop Board and the Central Committee of the Dunlop Pirelli Union should know the inflation adjusted results for both 1974 and 1975 by the time of the Accounts Board in May 1976. We propose to use the present Dunlop Pirelli Union inflation accounting system to achieve this and indeed we will be paying much more attention to this important information for all management accounting purposes in the future."

(4) "Since 1st January 1975, all Union Companies have operated a system of inflation accounting for profit reporting purposes... and this is almost identical to the Sandilands

proposals. The system can readily be adapted to provide, in addition, balance sheet current values....."

(5) "You should return your 1974 and 1975 figures, set out on the lines of the attached profit and loss account and Balance Sheet, for each consolidated group....."[2]

(6) "It will not be necessary this year for you to complete the previous C.P.P. accounting figures....." "Your Auditors should report on both the 1974 and 1975 figures in the form shown below, by 31st March 1976.

(7)AUDITORS REPORT (Suggested by the circular)

"In our opinion, the attached statements fairly present the inflation adjustment figures in accordance with Treasurer's circular of 6th February 1976 and Group Comptrollers circular of 2nd September 1974."

Attached to the circular is a Profit and Loss Account, and Balance Sheet, with explanatory notes. The accounts are prepared in four columns under the following headings::

(1) Notes

(2) Historical Financial Accounts.

(3) Current cost adjustments.

(4) Current cost accounts.

As can be seen from the above circular, the Dunlop Companies have been adjusting their accounts for some time. Since 1976, their accounts have been adjusted in line with Sandilands recommendations. The suggested 'auditor's report' on inflation accounts is an intelligent move aimed at implementing inflation accounting. C.P.P. accounts were prepared in 1975 after it had been

recommended by the Accounting Steering Committee (ASC).

PHILIPS (K) LIMITED

The PHILIPS' ELECTRICAL companies were the pioneers in preparing accounts based on replacement values. The various subsidiary companies of the Philips Group located in East Africa base their accounts on replacement value. This system has been applied for over 40 years according to chief accountant of Philips Kenya Limited. Their management teams base their decisions on the relevant up-to-date information that is necessary to conduct a business with efficiency. They publish their external financial statements in current values only*.

Like the other subsidiaries of the Philips Electrical Industries Group, Philips Kenya Limited performs its accounting in accordance with a standard accounting manual issued by the company's headquarters.

The application of the current value theory is not merely a calcualtion technique used in preparing the annual accounts. It is integrated into the accounting system in all sections of the concern at every stage. In this way the Philips people have ensured that all information for management is compiled in current cost and that current costs enter into all management considerations and decisions.

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* Even in the Netherlands where the Head Office of the Philips Group of Companies is located, taxes are based on historical costs, although replacement-value accounting is accepted by law in that country.

Philips Kenya Limited commenced its operations ten years ago. It has always applied replacement cost in preparing its accounts. It does not prepare historical cost accounts at all. It produces replacement-cost accounts as the primary statement for internal use, for its shareholders and also for statutory purposes. It includes a complete set of standard-cost accounts based on replacement cost, and, as a matter of policy these costs are up-dated every month to current prices. The financial statements are prepared on the same basis, and the published accounts are drawn up in replacement cost terms. These statements are arranged along conventional lines so as to enable easy extraction of the historical costs for legal and taxation purposes. An array of adjustment accounts are added to the historical-cost accounts to implement the replacement-cost accounting. There are two major areas of adjustments. These are on:

(a) Inventories and

(b) Fixed assets, where there is an inevitable delay before expenditures incurred find their way into recorded costs.

Let us look at the treatment of these two types of assets

INVENTORIES (STOCK)

Raw materials are kept on the replacement value basis. The policy is to revalue the stock monthly or more often, e.g., bi-monthly if there are high and frequent fluctuations in prices. In practice, the stock is revalued at intervals depending on the fluctuations in foreign exchange rates. This is so because the

the company imports most of its materials from Holland where the headquarters is located. Price lists are received from overseas and local suppliers as often as the company requests them. The stock is revalued either when the rate of money exchange changes, or when local suppliers supply materials to the company at significantly different prices. The difference between revalued costs and the list prices is credited to a Stock Revaluation Reserve Account (assuming increase in prices) and debited to the stock account. In other words, if the stock is adjusted upwards, the entry required is:

Dr. Stock

Cr. Stock Revaluation Reserve.

The cost of sales is then adjusted to the new prices. Work-in-progress is costed at the increased prices (or the latest prices) of labour and raw materials, and overhead is apportioned appropriately as in historical cost accounting. Finished goods are treated in the same way as raw materials. Accounts are opened for different types of raw materials and finished goods, and these accounts are given standard code numbers - i.e. numbers which are used by all subsidiaries all over the world. In 1975, when there was great and more frequent fluctuations in prices, revaluation of stock and finished goods took place three times.

FIXED ASSETS

The policy is that all fixed assets should be revalued at least once a year. If the exchange rate falls or rises

rapidly and more frequently, the revaluation will be done more often. Let us look now at each class of fixed assets.

BUILDINGS

Buildings are revalued every year by professional valuers. These valuers determine the replacement cost of buildings at a given date. If the buildings account has to be changed, the increased value is entered thus:

Dr. Buildings

Cr. Revaluation Reserve (Buildings)

The Philips (K) Ltd. also write up the balance of depreciation provision on buildings at the same time. The change in depreciation is also charged to the Revaluation Reserve account.

MACHINERY

The company is instructed by the headquarters on how the price of a machinery has changed and on what rate is to be used in revaluing the machinery. Alternatively, the headquarters instructs on what a particular machine could cost at a given point and the subsidiary is then given the rates of increase in a specific price index. If the rate of increase is 7% this rate is then used to appraise the cost of the machine. This increase in value of the machine is entered in the books by debiting the machine account for the amount of the increase, and crediting the machine Revaluation Reserve by same amount. The depreciation account is also adjusted accordingly by debiting Revaluation of

fixed assets, and crediting Accumulated Depreciation by the amount of increase in value. The same happens in respect of vehicles. Land is not revalued. Adjustments of costs of locally purchased machinery are made using prices based on local quotations.

Monetary assets are currently not revalued. In October 1976, the company received instruction from headquarters to the effect that monetary items should be valued to determine holding losses or gains, but these instructions have not yet been implemented. The instructions were issued with a manual guide to show how the revaluations should take place. The chief accountant is studying the instructions before they are implemented.

Note that the implementation of the new instructions will bring in an additional number of new adjustments, and it will also change the whole revaluation process. What exists at the moment (before the issue of those instructions) is that there is decentralized calculation of holding gains and losses. In other words, the calculation of holding gains or losses has therefore been left to the discretion of the chief accountants of different subsidiaries. Philips Kenya Limited does not calculate these gains and losses at the moment.

Labour costs are revised once every year, at the time when adjustments of salaries and wages are effected. The salary of workers is based on the calculated rise in costs in the consumer price index. The new salaries and wages form part of the ongoing budgets.

INTANGIBLES are very specific and are looked upon from case to case,

and each class is treated in its own merits. As the chief accountant said, the "usual prudent principle is to utilize more than the replacement value of the intangibles." In addition, he indicated that intangibles are treated in the same way as in the case of historical-cost accounting.

Commenting on whether the company encounters any problems in its replacement-value accounting, he stated that they do not experience any specific problems because the replacement value system has been practiced for over 40 years. However, he agreed that the local users of financial statements here in Kenya may find it difficult to comprehend inflation accounts, and he suggested that the University of Nairobi here in Kenya should begin to teach the subject of inflation accounting seriously. He cited two most important advantages of replacement cost accounting:

(1) It makes everyone in a company, especially commercial managers, constantly aware of today's increasing cost prices. Therefore, selling prices and other costs are established with a full realization and allowance for the inflationary forces at work.

(2) It is a method of computing that part of annual profits that can be distributed without affecting the total purchasing power of the company; and by applying the system, the company can allow for the diminishing value of money and thereby gain safely from price fluctuations.

B.A.T. (Kenya) Limited is one of a group of companies which started a piece-meal approach to inflation accounting. The B.A.T. group of companies began revaluing their assets about 15 years ago. According to the cost accountant of B.A.T. Kenya Limited, the emphasis on revaluations has been increasing over the years. The fixed assets are revalued using specific price indices worked out by the company. The company does not employ professional valuers to do the revaluation. Sometimes, B.A.T. Kenya Limited revalues all fixed assets, but in most cases the revaluation is done for selected fixed assets every two years. The cost accountant agreed that the understatement of depreciation by use of historical-cost accounting is a serious problem.

4-4 QUESTIONNAIRE DESIGN AND BUSINESS RESPONSES

As already indicated at the start of this chapter, seventy questionnaires were sent out and twenty four of them were duly completed and returned to me. In this section, we shall see how the questionnaire was designed and also the responses given by companies. Only 'YES RESPONSES' are presented here, expressed in percentages of total responses. The 'Yes Responses' are presented under three captions (or headings), namely:

(1) Quoted Companies, i.e., public companies quoted on the Nairobi Stock Exchange.

(2) Non-quoted Companies and

(3) Total number of responses. The percentage responses are calculated as follows:

Quoted: $\frac{\text{Yes Responses of quoted companies}}{\text{Number of Quoted Companies which responded}} \times 100$

Non-Quoted: $\frac{\text{Yes Responses of non-quoted companies}}{\text{Number of non-quoted companies which responded}} \times 100$

Total: $\frac{\text{Yes Responses of all companies which responded}}{\text{Total number of companies which responded}} \times 100$

QUESTIONNAIRE AND THE RESPONSES

Qu. 1 : THE QUESTION SEEKS THE OPINION OF COMPANIES ABOUT PRESENT HISTORICAL-COST ACCOUNTING

	YES RESPONSES(%)		
It has been argued that during inflation, conventional historical-cost Accounting provides information which is IRRELEVANT to decision making by investors, creditors, management, and other interested parties. Do you agree?.....	Quoted	Non-Quoted	Total
	46	55	50

COMMENTS The responses were unexpectedly low because of the nature of the question. Many companies were not in favour of the use of the word 'irrelevant'. However the average responses reveal that conventional accounting produces irrelevant data to users of accounts. Some of the firms stated that the historical

cost data is not irrelevant, but 'distorted' or 'misleading'. Others stated that the conventional data can be irrelevant only in times of "high inflation". This view disregards the fact that "high inflation" is a subjective term. To some people, an inflationary rate of 4% is high, while to others, a rate of 10% is low.

Some of the responding firms expressed their opinions that historic-cost data is 'certainly inadequate,' but not irrelevant. To purchase a company or other business concern, current values of assets are often required. The chief accountant of Brooke Bond Liebig stated: "Information provided on a historical basis is not irrelevant. If inflation accounting becomes an accepted practice it is still likely to be supplementary to the historical accounting schedules."

Qu. 2 TO FIND OUT WHETHER THE IMPACT OF INFLATION SHOULD BE REFLECTED IN THE FINANCIAL STATEMENTS

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
Inflation in East Africa in recent years, particularly in Kenya, has threatened economic survival. Do you consider that accounts prepared for management and/or shareholders should reflect the impact of inflation?	86	91	88

COMMENTS

The high rate of 'Yes Response' by all types of companies shows clearly that there is need for change in the present system of accounting by most companies. Inflation-accounting financial statements will better reveal the truth of the current performance of a business. The following are some of the specific responses given by firms:

* Yes, but the crucial point is: will the Government make allowance for it (reflection of inflation impact) in tax legislation?
* Definitely historical-cost accounts do not show the bigger margins required to compensate for increased costs of holding more expansion stocks.
* Yes, but only in additon to normal historical-cost accounts and should be treated with reservations.
* Yes, but inflation accounting is as confusing as historical-cost accounting.
* In theory, yes, but in practice this would probably lead to confusion.

The above responses indicate a general feeling of the firms in Kenya about reporting inflationary effects in financial statements. Some firms reserved their comments on this question. One firm remarked: "Surely, it depends on what modifications are intended." Another firm said that it could not comment on this question because there is no definite emergent concept to replace historical-cost accounting.

* Qu. 3 SEEKS TO KNOW 'ON WHAT' ITEMS THE IMPACT OF INFLATION SHOULD BE REFLECTED

If your answer to Q2 is yes, should impact of inflation be reflected on:	YES RESPONSES(%) Quoted	Non-quoted	Total
a) Fixed assets	77	82	79
b) Depreciation	69	91	79
c) Cost of stock consumed during the year	77	73	75
d) Cost of holding cash or other monetary assets	69	55	63
e) The gain on equity from borrowing	62	64	63

COMMENTS

As can be seen, most firms agreed that impact of inflation on fixed assets, depreciation, and on the cost of stock consumed during the year should be reflected in the annual accounts. They stated that this reflection of inflation is particularly necessary for capital-intensive firms because aggregation problem is worse in these firms, and the users of the financial-data of these firms must interpret them cautiously. During inflation depreciation based on the understated fixed assets leads to insufficient funds retained for future 'survival' of a business.

* The responses for each group for all questions (i.e. a,b,c,....e) do not add up to 100% because varied answers were given to each question.

There were mixed responses on item (c) and (d) above. Some firms had the feeling that inflation should be reflected in respect of these items; others had an opposite view and they stated that items (c) and (d) are particularly difficult to quantify. Some firms held a similar view to that of Sandilands to the effect that "cash and other monetary assets" are often held at current prices, and that there is therefore no need to reflect inflationary effect in respect of them. One firm stated that the impact of inflation in items (d) and (e) is not as high as for (a), (b) and (c), but the decision makers should be aware of the fact that inflation has an effect on both sets of items. Another firm stated that if inflation accounting is adopted, then it should cover all items in financial statements.

Qu. 4 TO FIND OUT THE ANTICIPATED EFFECTS OF REFLECTING THE IMPACT OF INFLATION ON FINANCIAL STATEMENTS

	YES RESPONSES (%)		
The present financial statements of companies in Kenya are prepared on the basis of historical costs. Indicate whether modifications to conventional accounting will have:	Quoted	Non-Quoted	Total
* a) Better results to financial statements users	62	100	79
b) Confusing results to financial statements users	31	27	29
C) No effect on accounting information	0	9	4

* For question a) eight quoted companies gave 'yes response' while eleven non-quoted companies also agreed with the question.

COMMENTS

The above response percentages affirm the belief that modifications to a historical-cost accounting system will definitely provide beneficial results to users of financial statements. The answers indicates a belief that historical-cost accounting data is not sufficient, particularly when it comes to making investment decisions. The conventional accounting system is deficient in calculating the rate of return on invested capital, the 'fair' amount of taxes to be paid, the proportion of profits to retentions, and the like. Obviously the majority of respondents believe that such inadequacies will be reduced if inflation accounting is adopted. Only a few firms stated that inflation accounts would confuse the users of financial statements. It is of course true that the information will be confusing initially, especially to the laymen. This is an inevitable position. Even historical financial statements are not understood by all users of the accounts and many shareholders cannot interpret them correctly. Inflation accounts are likely to confuse them even more. This calls for a re-education of users of accounts on how to interpret inflation accounts in the manner suggested in recommendation No.14 of Section 4-5. Even those who seem to understand conventional accounts must be re-educated on both the faults of conventional accounts and the benefits of modifying them.

Only 4% of the total number of firms surveyed felt that inflation accounts would have no effect on the usefulness of accounting information. Such a view may be a reflection that

these firms have not given enough thought to the effects of price-level changes on their operations and performances. Alternatively these firms may not own any long-term fixed assets. However, it was the feeling of many firms that inflation accounts will give more realistic results of the operation of a firm. The information of modified historical-cost accounts will give a current' picture instead of 'historical' picture. Some firms felt that inflation accounting would have both beneficial and confusing results to users of accounts. One firm remarked, however, that the necessity (for modification of accounts) is not obvious in an economy such as Kenya's. It felt that the cost of producing more sophisticated figures as well as historical-cost accounts would be 'detrimental', but it did not go on to explain how 'detrimental' the modification would be. One firm which indicated that the modifications would produce confusing results stated: "The complexity of such modifications would be confusing to the public for whom the statements are prepared; simplicity and objectivity is more important in making statements. Decision makers would find it impossible to make any comparisons of financial statements, since all these modifications would be subjective and based on certain assumptions which may not necessarily be right, and unscrupulous people will exploit this subjectivity to suit their own ends. We just don't have the statistical data necessary." The chief accountant of Brooke Bond Liebig who supported the above view also stated: "We do not believe inflation accounting will be generally understood or accepted in Kenya

for some years to come."

Intitial problems of understanding inflation accounts are anticipated, but this will not, in my opinion, prevent 'dynamic' and 'progressive' accountants from experimenting and, eventually, adopting the alternatives to historical-cost accounting.

Qu. 5-13 TO FIND OUT THE EXTENT TO WHICH MANAGEMENT OPINIONS ARE PUT INTO PRACTICE

	YES RESPONSE (%)		
	Quoted	Non-Quoted	Total
*Qu. 5. Do you make any adjustments to your financial statements to reflect the impact of inflation on items in 3?	8	100	50

COMMENTS

It is surprising to learn that very few quoted companies make some adjustments of asset values in their accounts. This means that the public is kept ignorant of the current values, and hence of 'current performance' of these firms. It is, on the other hand, encouraging to note that most non-quoted companies make the adjustments mainly for management use. Such adjustment, if done frequently (i.e. every after two to four years), will give management an opportunity to make more efficient decisions.

* Only one quoted company (Dunlop (K) Ltd) indicated that it makes adjustments to reflect the effects of inflation. All the eleven non-quoted companies agreed that they make adjustments to their accounts.

Dunlop (K) Limited, East Africa Industries, Consolidated Holdings Company Limited, B.A.T. (Kenya) Limited and Philips (Kenya) Limited are among the companies which make frequent adjustments to their fixed assets. Brooke Bond Liebig (K) Limited, which makes the adjustments, said that it makes those adjustments "to the extent that its fixed assets are revalued regularly." The Philips Group of Companies have been employing current replacement values for over 40 years.

Some of the firms which do not make the adjustments stated that they do "highlight inflationary effects in commercial and written information accompanying financial statements" (i.e. in notes to financial statements). Some subsidiary companies stated that they follow the policies laid down by parent companies and, for that reason, they cannot begin adjusting their accounts until they are advised to do so by their head offices.

	YES RESPONSE (%)		
	Quoted	Non-Quoted	Total
Qu. 6 In preparing budgets and management accounts, do you make adjustments to actual and forecast cost to take into account the price-level changes?	38	82	58

COMMENTS

It is true that some adjustments are made to actual and forecast costs in budgeting but this is arbitrarily done in most cases. There is no systematic policy on determining the 'inflation factor.' Some (assumed) inflationary factor is loaded to anticipated costs in the preparation of budgets. Some firms do not experience any problems in budgeting certain costs like wages and salaries whose inflationary factor can easily be determined. It is, however, not easy to determine the inflationary factor on items exchanged in the world market where the firm cannot predict with accuracy future fluctuations in prices. Those firms already using 'replacement costs' or 'replacement values' argue that the use of current values in their accounts automatically accounts for budgets and post-calculations. The calculation of a reliable inflationary factor is a function of experience in budgeting of the officers concerned, and also of their predictive ability of future trends based on past events. One firm stated that, "the bulk of our income is from exports. We have enough of a problem in forecasting exchange rates without the further complication of price-level changes." This firm is, impliedly, against inflation accounting.

Qu. 7 If the answer to Q. 6 is yes, are the adjustments linked to:

	YES RESPONSE(%)		
	Quoted	Non-Quoted	Total
a) A general price index?————	15	27	25

Qu. 7 cont.

b) Specific price index? ----------	8	27	17
c) Some other basis? ----------	54	27	42

COMMENTS

A good number of firms make use of a general price index in adjusting financial statements. Those who use b) or/and c) stated that there is no one good general price index that can be applied to all industries. Different industries experience specific changes in prices which are peculiar to their businesses. Therefore, it appears that a general price index is not assumed by them to be a good average of all the specific indices.

Firms which indicated that they use c) do apply the 'current values' which in essence includes specific price indices (i.e. b)). Some firms thought that there are better methods of adjusting accounts other than using a) or b). Some of these firms offered the following comments:

* Adjustments will depend on a firm's own assessment of likely future events.
* Current market prices are better.
* Across the board inflationary factor of x% is used.

Note that some of the above comments are unclear and imprecise. For example, the use of 'across the board inflationary factor x%' does not tell precisely what specific policy is followed. This method may be similar to the use of a general price index.

Qu. 8 TO FIND OUT THE BASIS OF CALCULATING DEPRECIATION

Is depreciation in your accounts based on:

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
a) Original historical of an asset	77	64	71
b) Estimate of replacement cost of some asset?	23	0	13
c) Some other basis	8	9	8

COMMENTS

It can clearly be seen that companies in Kenya predominantly base depreciation on the historical cost of fixed assets. This confirms the dominant use of the conventional accounting system in Kenya. During a period of rising prices, the book values of fixed assets are therefore understated; and the depreciation based on these values tend to be under-stated. This means that less depreciation is charged against profits, thus resulting in high reported net profits available for distribution, and consequently a low retention of funds through the recording of depreciation as an expense. One firm argued that, since taxation in Kenya is based on capital allowances, the under-calculated depreciation does not affect the firm unfavourably. The firm seems to have ignored the fact that capital allowances are worked out on the basis of historical book-values of the fixed assets. If the current values of fixed assets

were legally allowed as a basis for calculating capital allowances, firms would then be paying less tax during a period of inflation.

Those firms which have started revaluing their fixed assets tend to base depreciation on the revised costs of those assets. The responses tend to indicate that many non-quoted companies base their depreciation on revalued costs. Those firms which gave positive answers to c) actually base their depreciation on the current values of those assets which, in essence, are normally calculated on the basis of their replacement costs. One firm stated that it plans to use replacement cost in the future if inflation accounting is adopted: Another firm indicated that it writes off historical cost more rapidly than is normal to compensate for inflation. Some firms which indicated the use of c) stated that recent values of assets are used. Some base depreciation on both historical costs and on revalued figures. The East African Railways uses revalued costs which are determined after every five years, and also uses a historical cost basis. An account is opened for the differences between historical and revalued amounts.

Qu. 9 TO FIND OUT WHETHER REVALUATION OF FIXED ASSETS IS DONE

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
Have you revalued your fixed assets in recent years?			

Qu. 9 cont.

a) Land	31	36	33
b) Building	38	64	50
c) Plant	23	45	33

COMMENTS

The responses indicate that revaluation is done most often on buildings, and mainly by non-quoted companies. E.A. Railways revalued the three kinds of assets in 1971, and again in 1975. It values its assets after every five years and depreciation is determined on both revalued costs and on historical costs. Many firms revealed that they are in a preparatory stage for revaluation. Unga Company Limited, which revalues its three categories of fixed assets every 5 years stated that it hopes to revalue them more frequently in the future. Some firms stated that they own none of the fixed assets mentioned, but office machinery and cars which they do own have not been revalued.

Qu. 10 TO KNOW THE BASIS OF REVALUATION

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
On what basis were the revaluations made ?			
a) Valuer's Report	38	36	38
b) Indices	0	9	10
c) Other evidence	15	9	33

COMMENTS

Firms which have revalued their assets indicated that they at least based their revaluation on professional assessment reports. Very few firms used available price indices. Some firms used current market values while some stated that they use "their technical knowledge" to determine the asset values. The latter companies actually either work out the specific price indices using suppliers' quoted prices or they work out the cost of building or producing a similar fixed asset (an engineering function).

Qu. 11 TO FIND OUT THE PREMISES OF THE PAST REVALUATION

	YES RESPONSE (%)		
	Quoted	Non-Quoted	Total
Was the past revaluation made			
a) Generally on the basis of going concern/existing use of assets?	38	45	42
b) On any other basis?	15	0	8

COMMENTS

Few comments were provided in answer to this question, either because the companies did not understand the question properly or because they actually had no comments to make. If the revaluation was made on the basis of going concern or existing use of assets, the implication is that the firm intends to replace the assets when they become worn out, and therefore the

assets are revalued on the basis of Replacement Cost or Replacement Value. The alternative is that the assets can be valued at their economic value (or present value) if this is feasible. Those firms which gave positive answers to b) are probably those firms which either used net realizable values, or a combination of replacement cost and net realizable values to determine the current values of their assets. Only one firm indicated that it based its revaluation on property market values. Personal interviews with financial managers revealed that many firms revalue their assets on the basis of going concern of their business and also on the existing use of their fixed assets. This confirms the picture given by the above-tabulated responses, particularly with respect to non-quoted companies.

Qu. 12 DISCLOSURE OF REVALUATION IN ACCOUNTS

	YES RESPONSE (%)		
	Quoted	Non-Quoted	Total
How were the revaluations disclosed to financial statement users?			
a) In notes to financial statements	23	73	46
b) In brackets to each respective accounts	0	0	0
c) In management Reports	0	0	0
d) Some other basis	15	18	17

COMMENTS:

The responses indicate that revaluations are disclosed mainly in notes to the financial statements. This is appropriate. The Unga Company Limited stated that its 'net gain/loss due to inflation as reflected in money exchange rates is taken as a financial gain (or loss) on the income statement. Many firms disclose the excess value in both balance sheet and in notes to financial statements. In the balance sheet, the excess figure is shown as a 'Revaluation Reserve' or 'surplus on revaluation' or 'Capital Reserve.' The reserve is then explained and shown in detail in the notes to financial statements. Marshals (E.A.) Limited indicated that any excess on revaluation is treated as an amendment of fixed assets value and is transferred to "Capital Reserve." Grindlays Bank International indicated that the revaluation were "Incorporated in the allowances". The company did not, however, specify the allowances mentioned. Rarely do companies disclose their revaluation in parentheses to respective accounts or in management reports.

Qu. 13	YES RESPONSES (%)		
	Quoted	Non-quoted	Total
Do you maintain a policy of retaining sufficient profits to cover the estimated cost of replacing fixed assets?	62	64	63

COMMENTS

It is encouraging to realize that many firms maintain this policy. The following comments were given by the firms on the above question:

* In practice retained profits including depreciation do not normally cover our current level of capital expenditure on fixed assets but this includes considerable expansion of our labour housing as opposed to replacement of assets.
* This is covered in our cash budgets.
* We use capital budget appropriations.
* This is implicit in our system of accounting (of Philips Kenya Limited).
* Distribution policy of banks is conservative (Barclays Bank International).
* No specific reserve is maintained for replacement over and above the depreciation charge (Consolidated Holdings Limited).
* We are not a profit making organization (coffee Board of Kenya).
* No. Not as such, but our reserves are sufficient to do so. Not our cash though. (Mumias Sugar Company).
* Yes. Depreciation is charged to Profit and Loss account to cater for this (E.A. Railways).
* Any reasonable business must do so (Dunlop Company (K) Ltd).

The above comments show that there are various ways used by the firms to retain enough funds for replacement of assets.

But it seems that many of them rely on depreciation amounts, which, under historical-cost accounting, are not sufficient for the intended replacements.

Qu. 14 - 21 GENERAL THEORETICAL QUESTIONS

There has been a lot of debate, particularly in the U.K., U.S.A., Canada, and Australia, on whether general price indices or current values of assets should be the basis for inflation accounting. General Price-Level Accounting uses general price indices; current value (or current cost) accounting is based on current market values.

Qu. 14 Which one would you recommend:

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
a) General Price-Level Accounting?	0	9	4
b) Current Value Accounting?	46	55	50
c) Both a) and b)?	15	18	17

COMMENTS

The responses show that general price-level accounting is less favoured than current value accounting in preparing inflation accounts. Those who favour price-level accounting add that its application requires competent compilations of

price indices. Many firms favour the use of current values, and the following are comments that were given in favour of current-value accounting:

* Current value accounting (CVA) might be easier to implement than price-level accounting given the existing state of staff/technical development.
* CVA is more appropriate for stock purchased by a manufacturer but general price level accounting (GPLA) is appropriate for common items, cash, debts and buildings.
* In many countries there are problems encountered in obtaining adequate indices, and hence GPLA is unsatisfactory.
* It is very difficult to determine an appropriate general price index. Therefore a CVA is the straight forward method and it gives more accurate results.

Some of those firms which recommended both CVA and GPLA stated that both methods have merits and demerits. The National Bank of Kenya stated that "to make correct decisions we need to know the current value of the assets and also be able to isolate the change that is real, and the change that is inflationary".

Brooke Bond Liebig Kenya Limited stated that "GPLA (CPP) can be used for monetary items and CVA for fixed assets". Another firm said that all situations differ and that it is difficult to standardize. A number of firms declined to recommend any of the options given. One firm commented that "there has been obvious argument for and against both methods. Highly qualified members of accounting bodies around the world are trying to reach a decision

on the best method."

Que. 15 Does any of the two approaches to inflation accounting have merits?

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
a) Current Value Accounting	54	73	63
b) General Price-level Accounting	38	45	42

COMMENTS

Responses to this question indicated opinions that current value accounting (CVA) has more merits than general price-level accounting (GPLA). A number of firms were for both a) and b), indicating that both CVA and GPLA have merits but CVA could be more convenient in Kenya. Consolidated Holdings shared the same view with Kenya Shell Co. Ltd. in this respect. Hutching Biemer Ltd. stated that CVA indicates the value of the assets as they are worth to the company. See also comments to Qu. 16 below.

Qu. 16 Do you anticipate any problems in the two approaches?

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
a) Current Value Accounting	31	55	42
b) General Price Level Accounting	31	55	42

COMMENTS

The responses tend to indicate that the respondent firms were in agreement that both CVA and GPLA present problems in their application. This is not actually the case. Some firms stated that CVA has problems, some indicated that GPLA has problems. Some firms felt that it is difficult to get current values of specific or unique assets, e.g., the current values of a plant. A large number of firms suggested that it is easier to apply current-value accounting than GPLA. It is not difficult to get the current values when you have suppliers' price indices or when professional valuers are employed. The strongest argument against GPLA is that there is hardly any one suitable general price index to be applied to all industries.

Qu. 17 If your company is a subsidiary to a parent company in the U.K. or U.S., or other foreign country which adjusts its accounts for inflation, what impact has this got on your accounting system?

COMMENTS

None of the quoted companies is a subsidiary of a foreign parent company. Very few foreign subsidiaries indicated that they have been influenced by parent companies on inflation accounting. These subsidiaries include Consolidated Holdings, East Africa Industries and Dunlop Kenya Limited. Dunlop Kenya Limited has been directed by Dunlop International to prepare inflation accounts based on the Sandilands recommendations. Caltex Oil Kenya Limited stated that it has developed methods of satisfying both local and U.S. requirements. The Philips Kenya Limited, like other subsidiaries of the Philips Group, prepares accounts based on replacement value of assets. Some of these subsidiaries indicated that no adjustments are made in accounts of their parent companies.

Qu. 18 If adjustments for inflation were to be made, how should they be reported to financial statement users?*

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
a) Preparation of supplementary statements to historical cost statements?	62	64	63

* Compare Qu. 12 and Qu. 18. They tend to be similar. The difference is that Qu. 12 is directed to firms which had made revaluations on items in Qu. 9 while Qu. 18 is directed to all firms, whether they are making any adjustments or not.

Qu. 18 Cont.

b)	Footnotes to historical cost statements?	0	36	17
c)	As a primary report	15	18	17
d)	Some other basis?	0	45	4

COMMENTS

Many firms were of the opinion that inflation accounts should be prepared as supplementary reports to historical-cost statements. The supplementary statements would enable the users of accounts to understand the differences between the conventional accounts and the inflation accounts, and also to understand the benefits of inflation accounting, particularly when they compare the asset values, and the end-year profits in the two sets of statements. Some firms suggested that historical-cost statements should be retained because the users of financial statements understand them better than they do the inflation accounts. It was claimed that, if the supplementary statements are not prepared, readers of financial statements, particularly shareholders, will begin to suspect the motives of accountants, i.e. they may suspect that the accountants have done away with the historical reports for their own benefits. A few companies agree that preparation of inflation accounts should be undertaken as primary reports. Philips Kenya Limited, which advocated for primary reports of inflation accounts maintained that supplementary statements would certainly be an improvement over historical-cost accounting, but it expressed the fear that these statements might pose problems

to company auditors. "Which one of the supplementary reports presents a 'true and fair view' of a company?, the firm asked. It added that only valuable and proper presentation is the basis of its replacement-value accounting, which the firm prepares as a primary statement.

Qu. 19 Do you feel that you are paying taxes on capital because there has been no adjustment to the financial statements for chages in asset values?

YES RESPONSES (%)

Quoted	Non-Quoted	Total
23	45	33

COMMENTS

The responses show that a few firms believe that they are paying more taxes than when inflation adjustments might be made. The National Bank of Kenya feels that it pays more taxes than necessary during the current inflationary periods because of the understatement of its fixed assets, and hence lower capital allowance approved for tax purposes. Brooke Bond Liebig was of the same view and wondered whether "the government would ever admit adjustment on statutory accounts for taxation purposes". Philips Kenya Limited also admited that taxes based on historical accounts profits may lead to erosion of capital during inflation. Some firms declined to answer the question unequivocally. They stated

that whether a firm will realize more or less profits after adjustment of accounts will depend on the nature of the assets held, and the extent to which inflation has affected those assets.

Qu. 20 Which cost selection method (valuation method) of inventory do you employ in your company?

	YES RESPONSES (%)		
	Quoted	Non-Quoted	Total
a) Last-in-first-out (L.I.F.O.)	0	18	8
b) First-in-first-out (F.I.F.O.)	38	45	17
c) Specific identification	31	0	13
d) Weighted-average	31	45	38
e) Other method	0	27	13

COMMENTS

A fair number of the firms employ that F.I.FO. or the weighted-average methods in their revaluations of inventory. No quoted company uses the L.I.F.O. method. Commenting on the L.I.F.O. method, various firms indicated that L.I.F.O. is not a suitable method in all seasons. (i.e. during both inflation and deflation). East Africa Breweries stated that L.I.F.O. is difficult to administer in practice. Kenya Shell felt that L.I.F.O. is not so good in times of rising product cost (that stock appreciation profits are taxed). Block Hotels Limited stated that L.I.F.O.

tends to build secret reserves, but it did not explain how this comes about. The Unga Company Limited objected to the use of the L.I.F.O., stating that it is a very poor method. East Africa Industries said that "L.I.F.O. is fine on a rising market but gives problems of overstating profits on a falling market". It added that the users of L.I.F.O. forget that commodity prices go up and down over time. Hutchings Biemer Company Limited share the above view. Some other companies felt that L.I.F.O. is a good method since it reflects actual costs of the items at current prices. Another firm stated that L.I.F.O leads to greater tax allowances in periods of increasing costs and should be employed for that purpose.

4.5 RECOMMENDATIONS

It is the desire of every user of accounts that relevant and up-to-date financial information be supplied by firms in their financial statements. Here in Kenya, historical cost accounting is the dominant system of accounting. As we have already seen, this system is deficient when prices are not stable. We have also examined the proposed alternatives to historical-cost accounting, namely, price-level accounting and current-value accounting. Inflation has been a threat and still continues to be a threat to the economic survival of Kenya and its people. It is time that the companies in Kenya started to think of providing relevant data in their financial statements.

In view of the prevailing local conditions, the author would like to make the following recommendations:

1) Replacement cost (or value) should be the basis of preparing the financial statements of all firms whose net worth is over K£5 million. Such large companies can afford to test and introduce the new system of accounting.

2) If a firm anticipates an end to its business in the near future, it should then, when it is possible, value its assets using current net realizable values.

3) The recommended replacement value accounting for a going concern should be applied to fixed assets, and the calculation of depreciation should be based on the new carrying values of the fixed assets.

4) Valuation of fixed assets should make use of:

(a) Specific price indices worked out by firms on the basis of the latest price quotations, or

(b) A professional valuer's report. The valuer's report should normally be reconciled with the management's estimates.

5) Fixed assets should be revalued after every two years to three years, the interval depending on the experienced rate of inflation, the cost of revaluing the assets and the convenience of the period to management.

6) Firms should avoid use of the economic value (or present value) concept because it may result in very subjective values and may even distort the results to be reported in the financial statements.

7) Stock (or inventory) should be valued on the basis of new price lists supplied by the sellers of goods.

8) In the valuation of both the fixed assets and stock, the difference between replacement values and historical costs should be disclosed in the balance sheet in a 'Revaluation Reserve' account. The detailed explanation of the 'Revaluation Reserve' should be provided in the 'notes to financial statements.'

9) Net holding gains (or losses) on monetary assets and liabilities should be calculated by the use of the Consumer Middle Income index which is prepared monthly, and published in Quarterly Digests and Annual Abstracts. These indices are readily available to companies when requested from the Central Bureau of Statistics, Ministry of Finance and Planning. Alternatively, these publications can be purchased from the Government Printer.

10) Net holding gains (or losses) should be reported in the income statement.

11) Intangibles should continue to be treated as they are under historical-cost accounting.

12) For the first 5-10 years, the inflation accounts should be prepared as supplements to historical-cost accounts. This will give the readers of those statements a reasonable period to get to understand the fundamental differences between the two sets of financial statements. The two sets of financial statements should be presented in parallel columns.

13) Funds flow statements based on both historical costs and budgeted costs should be prepared in addition to inflation accounts.

14) It is necessary that a program should be worked out for educating the users of financial statements, on the use of new accounting system. For both public and private companies, some of the fundamental points on inflation accounting should be highlighted at annual general meetings. In addition to such highlights, manuals on how to interpret inflation accounts should be prepared. For purposes of achieving general education on this matter, the subject of inflation accounting should be incorporated into the curriculum of business studies or business education or commerce, at Universities, colleges, polytechnics and institutes. Experts on the subject should be invited to these institutions as often as possible to give lectures on the subject.

15) The Institute of Certified Public Accountants, now in the process of formation, should undertake studies on inflation accounting, find out the possibility of implementing the system, and issue further guidelines on how to prepare inflation accounts.

16) Auditors should try as much as possible to encourage and help clients in preparing inflation accounts based on replacement values.

17) The Kenya Government should try to give both material and financial support to our Institute(s), once formed, to undertake a thorough study on this subject.

The above recommendations would act to facilitate the introduction of inflation accounting into our Kenyan companies. Once the subject is basically understood, more sophisticated inflation accounts can then be prepared.

REFERENCES TO CHAPTER 4

(1) Bamburi Portland Cement Company Limited, Report and Accounts, 1975, P.5. (This page contains the Chairman's Statement).

(2) A copy of a circular on inflation accounting was given to me by the accountant of Dunlop Kenya Limited Attached to the circular is an illustrative example of inflation accounts. The writer has not, however, reproduced these accounts.

CHAPTER FIVE

SUMMARY AND CONCLUSIONS

5.1 SUMMARY

There has been an upward trend in the general level of prices since the end of the Second World War. The term 'inflation' is therefore used in this thesis to take account of both increases and decreases in price of various individual goods and services. The inflationary trend is worldwide and it still continues.

Inflation reduces the purchasing power of money as a measure of value. The conventional historical-cost accounting system ignores this fact. The system incorrectly assumes that the value of a shilling is maintained during a period of price changes. The fixed assets are valued in the balance sheet at their original costs less the accumulated depreciation based on those historical costs. During inflation, the fixed assets tend to be understated. The depreciation based on those costs in therefore understated. The profits of a company are charged with less depreciation than normal, and this exaggerates the net profits available for distribution. Unless a company has a policy of retaining profits, it may end up paying divideds out of capital. The information provided by the conventional accounts tend to be irrelevant and distorted. People making decisions based on this financial information may be misled

Two approaches to inflation accounting have been proposed. These are price-level accounting and current-value accounting. Price level accounting is concerned with changes in the overall price level. It restates historical costs, using an appropriate general price index, into monetary units of same purchasing power. It is therefore an extension of historical-cost accounting. In the profit and loss statement, price-level accounting results in cost of goods sold and depreciation for a period being based on shillings of current purchasing power. The profit (or loss) for the period includes, as an additional item, gains (or losses) on any monetary items. Being an extension of historical-cost accounting, price-level accounting does not remedy many of the existing weakness of historical cost accounting. For example, the basic accounting principles employed still remain the same. Secondly, there is scarcely one appropriate general-price index that can be used to adjust the historical costs of items of various firms. Each firm is affected by inflation to a different extent depending on the nature of its assets and the business in which it is engaged. Price-level accounting, however, tends to make intra- and inter-firm comparisons which are more realistic than they are under historical-cost accounting. It also reveals the defects of historical system. Price-level adjusted financial statements include the effects of inflation on the results of business operations.

Current-Value accounting aims at valuing each unit in the accounts at either its current input price, such as replacement cost, or at its current output price, such as net realizable value.

A third current valuation basis is the present value of assets. This basis is, however, coneptually difficult and its application may introduce much subjectivity into accounts. For that reasen, this basis is theoretically accepted but is not favoured in practice.

Current-Value accounting assumes that it is possible to ascertain the current values of most assets, and this is infact not true in reality. Whether replacement cost or net realizable value or present value is the basis of valuation, it is difficult to establish a current value of assets such as blast furnaces or the current cost of a factory of a large manufacturing firm. However, the use of replacement cost or net realizable value or both, in valuing assets does tend to give more realistic values than are provided by historical-cost accounting or by price-level accounting. The advantages of current value accounting include the following:-

1) Information relevant to decision making is provided
2) A measure of current operating profit based on current revenue less current costs is a superior performance measure.
3) Adequate funds are retained through charging current costs to revenue for the replacement of assets consumed in production.
4) Current value financial statements have a good predictive potencial for decision making.
5) Current-Value information on asset resale prices is essential to protect shareholders in take-over situations, and to protect creditors generally.

On the whole, current-value accounting is superior to both historical-cost accounting and price-level accounting. Most decisions made by managements require a knowledge of the current values of assets. For example, a decision on whether to sell or retain an asset will be based on realizable value and use value.

The accounting profession has made much progress in proposing methods of reflecting the effects of inflation in financial statements. The first method to be proposed was similar to price-level accounting. Recently, however, the debate has tended to favour current value accounting. Steps are being taken in Britain and Australia to implement current-value accounting. It is to be hoped that other countries would follow the lead of Britain and Australia so as to achieve an international improvement in accounting reporting practices. Kenya is among the developing countries which have not yet recognized the importance of proper inflation accounting as a vital element to the reporting of current and more relevant financial information.

5.2 CONCLUSIONS

The recently increasing discussions on accounting for price-level changes provides evidence that the accounting profession is determined to replace historical cost accounting with a better system of accounting. Such replacement appears to be needed and inevitable. The United Kingdom, Australia and

probably the United States are likely to take leading positions in introducing the needed new systems. Judging from the wave of opinions in the current accounting literature, it appears likely that it will be current-value accounting that will replace historical-cost accounting. The views of Kenyan companies, gathered during my survey, indicate that it is current-value accounting that would be welcome. This was clearly revealed by the responses given by the companies which have been presented in Chapter Four above.

It may be a long time before our indigenous companies begin to prepare full inflation, accounting statements. This is true because of many current problems, namely;

(1) We do not have accountants who are qualified enough to prepare inflation accounts acceptable to management.

(2) It will take a long time to train both management people and the outside users of financial statements on how to interpret reported inflation accounts. The first introductions of inflation accounts are likely to meet a great resistence from the intended beneficiaries of the financial statements.

(3) We do not have a local Institute of accountants as yet. The Institute of Certified Public Accountants is in the process of formation and we hope that it will be registered by December 1978. In view of the fact that many of the accountants in Kenya are not quite conversant with inflation

> accounting, the Institute, when formed may not be strong enough to formulate firm and conclusive recommendations on inflation accounting for a good number of years. However, it is to be hoped that we shall be able to establish good standards of inflation accounting without undue delay.

Once inflation accounts are accepted for taxation purposes, the companies may have to pay less taxes than they do under the conventional accounting system. Less dividends will be paid out because less profits will be reported. At the outset, this may discourage investments, but as the investors come to understand the true message of inflation accounts, more investment will be realized. Because the companies could be paying less income taxes and less dividends, there could then be large retentions of profits which would then be reinvested. This would imply less reliance on borrowings and more rapid expansion of many businesses.

The premise of lower income tax payments when inflation accounts are prepared is a tenuous premise. It may not necessarily follow as such. The Government, in its annual budget, does not consider the mode of existing accounting system. It can still raise the required tax revenue regardless of the accounting systems in the country.

APPENDIX

REPRODUCTION OF RESEARCH QUESTIONNAIRE

Following is a reproduction of the questionnaire which the author used in his survey of the financial reporting policies of companies in Kenya.

TO WHOM IT MAY CONCERN

QUESTIONNAIRE ON INFLATION ACCOUNTING

(OR ACCOUNTING FOR PRICE LEVEL CHANGES)

The following is a questionnaire on Accounting for Price Level Changes. I am undertaking a research in this area as part of my thesis on INFLATION ACCOUNTING. The purpose of the questionnaire is to seek information on the approach of your company to:

(a) the recognition of inflation in internal and published accounts;

(b) the revaluation of fixed assets.

Please complete the questionnaire by placing a cross (x), in the appropriate boxes. More than one cross can be made where necessary. Any informative comments can be given in the spaces provided. Please forward the completed questionnaire to:

Francis M. Nyagari, at the above named address, (University of Nairobi address). by (DATE) _____.

It will greatly assist me, in interpreting your answers to the questionnaire, if you could enclose a copy of your company's latest published accounts when you return the completed questionnaire.

Qu. 1 THE QUESTION SEEKS THE OPINION OF COMPANIES ON THE PRESENT HISTORICAL COST ACCOUNTING

It has been argued that during inflation, conventional historical cost accounting provides information which is irrelevant for decision making by investors, creditors, management and other interested parties,

Do you agree?

YES ☐ NO ☐

COMMENT

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Qu. 2 TO FIND OUT WHETHER IMPACT OF INFLATION SHOULD BE REFLECTED

Inflation in East Africa in recent years, particularly in Kenya, has threatened economic survival. Do you consider that accounts prepared for management and/or shareholders should reflect the impact of inflation?

YES NO

COMMENT

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Q. 3 SEEKS TO KNOW ON WHAT IMPACT OF INFLATION SHOULD BE REFLECTED

If your answer to Q. 2 is YES, should impact of inflation be reflected on:

a) fixed assets — YES ☐ NO ☐

b) Depreciation — ☐ ☐

c) Cost of stock cash or other monetary assets — ☐ ☐

e) The gain on equity from borrowing. — ☐ ☐

COMMENTS

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Q. 4 TO FIND OUT THE ANTICIPATED EFFECTS OF REFLECTING THE IMPACT OF INFLATION ON FINANCIAL STATEMENTS

The present financial statements of companies in Kenya are prepared on the basis of historical cost. Indicate whether modifications to conventional accounting will have:

		YES	NO
a)	Better results to financial statement users	☐	☐
b)	Confusing results	☐	☐
c)	No effect on accounting information	☐	☐

Other Comments:

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Q. 5 - 13 TO FIND OUT THE EXTENT TO WHICH MANAGEMENT'S OPINIONS ARE PUT INTO PRACTICE:

Do you make any adjustments to your financial statements to reflect the impact of inflation on items in Q. 3?

YES	NO
☐	☐

COMMENTS

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Qu. 6 In preparing budgets and management accounts, do you make adjustments to actual and forecast costs to take into account the price level changes?

YES ☐ NO ☐

Comments

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Q. 7 If the answer to Q. 6 is Yes, are the adjustments linked to:

a) A general price index — YES ☐ NO ☐

b) Specific price index? ☐ ☐

c) Some other basis ☐ ☐

COMMENTS

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Q. 8 Is depreciation in your management accounts based on:

a) Original historical cost of an asset? YES ☐ NO ☐

b) Estimate of replacement cost of some asset ☐ ☐

c) Some other basis ☐ ☐

COMMENTS

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Qu. 9 Have you revalued your fixed assets in recent years

a) land YES ☐ NO ☐

b) Building ☐ ☐

c) Plant ☐ ☐

COMMENTS

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Qu. 10 On what basis were the revaluations made:

a) Valuer's report? YES ☐ NO ☐

b) Indices? YES ☐ NO ☐

c) Other evidence? YES ☐ NO ☐

COMMENTS

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Q. 11 Was the past revaluation made

a) Generally on basis of going concern/existing use of assets YES ☐ NO ☐

b) On any other basis YES ☐ NO ☐

COMMENTS

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Q. 12 How were the revaluations disclosed to financial statement users?

a) Notes to financial statements YES ☐ NO ☐

b) Brackets to each respective account YES ☐ NO ☐

c) Management reports

YES ☐ NO ☐

d) Some other basis

☐ ☐

COMMENTS

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Q. 13 Do you maintain a policy of retaining sufficient profits to cover the estimated cost of replacing fixed assets?

YES ☐ NO ☐

COMMENTS

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Q. 14 - 21 GENERAL THEORETICAL QUESTIONS

There has been a lof of debate, particularly in U.K., U.S., Canada, and Australia, on whether general price indices or current values of assets should be the basis for inflation accounting. General Price Level Accounting uses general price indices; current value (or current cost) accounting is based on current market values.

Q. 14 Which one would you recommend:

a) General Price Level Accounting YES ☐ NO ☐

b) Current value accounting ☐ ☐

c) Both of (a) and (b) ☐ ☐

COMMENTS

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Q. 15 Does any of the two approaches to inflation accounting have merits?

a) Current value accounting YES ☐ NO ☐

b) General Price Level Accounting ☐ ☐

COMMENTS

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Q. 16 Do you anticipate any problems in the two approaches?

a) Current value Accounting YES ☐ NO ☐

b) General Price Level Accounting ☐ ☐

COMMENTS

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Q. 17

If your company is a subsidiary to a parent company in say, U.K. or U.S., or in other foreign country which adjusts its accounts for inflation, what impact has this got on your accounting system?

COMMENTS

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Q. 18

If adjustments for inflation were to be made, how should they be reported to financial statement users?

		YES	NO
a)	Preparation of supplementary statements to historical cost statements	☐	☐
b)	Footnotes to historical cost statements	☐	☐
c)	As a primary report	☐	☐
d)	Some other basis	☐	☐

COMMENTS .....

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Qu. 20

Which cost selection method (valuation method) of inventory do you employ in your company;

		YES	NO
a)	Last-in-first-out (lifo)?	☐	☐
b)	First-in-first-out (Fifo)?	☐	☐
c)	Specific Identification)	☐	☐
d)	Weigh - average?	☐	☐
e)	Other method?	☐	☐

COMMENTS If you have any feeling about LIFO .....

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