

## ACCOUNTING IN AN INFLATIONARY ENVIRONMENT

## MACMILLAN SERIES IN FINANCE AND ACCOUNTING

The first edition of *Accounting in an Inflationary Environment* was published in the 'Studies in Finance and Accounting' series (General Editors: M. J. Barron and D. W. Pearce). Already published in this series are:

Michael Firth, *Management of Working Capital*

Michael Firth, *The Valuation of Shares and the Efficient-Markets Theory*

Kenneth Midgley and Ronald Burns, *The Capital Market: its Nature and Significance*

Terence M. Ryan, *Theory of Portfolio Selection*

The second edition of *Accounting in an Inflationary Environment* is the first book in a new series entitled 'Macmillan Series in Finance and Accounting' (General Editors: M. J. Barron and M. Bromwich). Forthcoming in this series is

M. J. Barron, *The Analysis of Company Cash Flow*

# Accounting in an Inflationary Environment

ROBERT W. SCAPENS

*Senior Lecturer in Accounting, University of Manchester*

**Second Edition**

M

© Robert W. Scapens 1977, 1981

Softcover reprint of the hardcover 2nd edition 1981 978-0-333-31899-7

All rights reserved. No part of this publication may be reproduced  
or transmitted, in any form or by any means, without permission.

First edition 1977  
Second edition 1981

*Published by*  
**THE MACMILLAN PRESS LTD**  
*London and Basingstoke*  
*Companies and representatives throughout the world*

ISBN 978-0-333-31900-0

ISBN 978-1-349-16613-8 (eBook)  
DOI 10.1007/978-1-349-16613-8

*Typeset in Great Britain by*  
**REDWOOD BURN LIMITED**  
*Trowbridge & Esher*

*Reproduced from copy supplied*  
*by Billing and Sons Limited*  
*Guildford, London, Oxford, Worcester*

The paperback edition of this book is sold subject to the condition that it shall not, by way of trade or otherwise, be lent, resold, hired out, or otherwise circulated without the publisher's prior consent in any form of binding or cover other than that in which it is published and without a similar condition including this condition being imposed on the subsequent purchaser.

In memory of Maud E. Scapens

# Contents

<i>Preface to the First Edition</i>	ix
<i>Preface to the Second Edition</i>	xi
<b>1 INTRODUCTION</b>	<b>1</b>
What is inflation?	1
Measurement of inflation	2
Effect of price changes on financial accounting	4
Effect of price changes on management accounting	6
Plan of the book	7
<b>2 HISTORICAL DEVELOPMENTS</b>	<b>8</b>
The German experience	8
Reactions in France	10
The United States and the United Kingdom	11
After the Second World War	13
Legislation in Germany and France	14
Recent developments	15
<b>3 CONSTANT PURCHASING POWER ACCOUNTING I – CONCEPTS</b>	<b>19</b>
The need for price-level accounting	19
The restatement process	22
Monetary items	25
Choice of an index	28
<b>4 CONSTANT PURCHASING POWER ACCOUNTING II – APPLICATION</b>	<b>32</b>
Illustration	33
Interpretation of C.P.P. accounts	38
<i>Statement of Financial Accounting Standards No. 33</i>	40
The extent of the difference	43
Conclusion	47

5	CURRENT-VALUE ACCOUNTING I – CONCEPTS	50
	Concepts of value	51
	Economic income	54
	Current-value accounting	56
	Holding gains	61
	Capital maintenance	65
	Summary of concepts	68
6	CURRENT-VALUE ACCOUNTING II – METHODS	70
	Illustration	70
	Capital-maintenance concepts	76
	Revolution or evolution?	80
	A gearing adjustment	85
	<i>Statement of Standard Accounting Practice No. 16</i>	87
	<i>Statement of Financial Accounting Standards No. 33</i>	95
	Implications	100
	Appendix: a comprehensive illustration	102
7	FINANCIAL REPORTING	113
	Historical cost versus current value	114
	Objectives of financial accounting	117
	A framework for accounting	120
	Information for investors	124
	The Sandilands Committee's objectives	128
	Conclusion	131
8	APPRAISAL OF CAPITAL PROJECTS	133
	A model for project appraisal	133
	Cash-flow estimates	136
	The cost of capital	139
	The treatment of inflation	142
	Conclusion	145
	Appendix: principles of discounting	146
9	PLANNING AND CONTROL	150
	Predicting price changes	153
	Budgets	154
	Liquidity planning	157
	Special decisions	162
	Control process	164
	Concluding remarks	168
	<i>Notes and References</i>	170
	<i>Index</i>	180

# Preface to the First Edition

The 1970s have brought rapid change to the accountancy profession in the United Kingdom and other countries. Many exposure drafts and statements of standard accounting practice have been published. The subject which has probably given rise to most discussion is the treatment of inflation. This decade may witness the end of the system of historic-cost accounting as the primary means of reporting financial information. The high rates of inflation in many Western countries in recent years have led to a serious reappraisal of the usefulness of historic-cost data. In general, this reappraisal has led to the conclusion that historic-cost accounting has serious shortcomings, particularly in a period of inflation.

The initial attempts to resolve these shortcomings involved the use of purchasing-power adjustments to remove the effects of inflation from historic-cost measurements. However, this approach was severely criticised by many accountants, businessmen and others. In consequence a more fundamental approach was sought. At the time of writing it is expected that historic-cost accounting will be replaced in the near future by a method of current-cost accounting.

The Accounting Standards Committee's *Exposure Draft No. 18* has been published, but the controversy has not ceased. The draft sets out the proposed standard for the application of the method of current-cost accounting advocated by the Sandilands Committee. Several aspects of *Exposure Draft No. 18* have attracted criticism and a number of prominent accountants and businessmen are pressing for additional time to prepare for the implementation of current-cost accounting. None the less it appears likely that current-cost accounting will soon replace historic-cost accounting in the United Kingdom.

The objective of this book is to explain the developments which



have taken place in recent years in the field of accounting in an inflationary environment. The system of current-cost accounting is discussed and, in addition, the prior developments (such as price-level accounting) are examined. In this way it is hoped that the present position will be put into perspective. The implications for financial and management accounting are considered.

It will be assumed that the reader has a basic knowledge of financial and management accounting, but an understanding of particular accounting procedures is not essential. This book is not a detailed manual of current-cost accounting. The principles and concepts of methods of accounting in an inflationary environment (including current-cost accounting) are discussed and illustrated by simple examples. The book is intended to explain the conceptual nature of recent developments in this area to both students and practitioners of accounting.

In conclusion I would like to express my thanks to Mr Roy Cromer and his Word Processing Department at the Ohio State University for the preparation of the typed draft and to Miss Debbie Jameson for her painstaking work in typing my revisions. My thanks are also due to my wife, Maureen, for her encouragement and her help with the arduous task of checking my manuscript.

*Manchester University*  
*January 1977*

Robert W. Scapens

# Preface to the Second Edition

Since the completion of the first edition of this book several important developments have taken place, particularly in the area of current-cost accounting. In January 1977 *Exposure Draft No. 18* had been published, and it appeared that current-cost accounting would soon replace historic-cost accounting in the United Kingdom. However, another three years elapsed before *Statement of Standard Accounting Practice No. 16* was issued. In the meantime we have had the *Hyde Guidelines* and *Exposure Draft No. 24*.

Developments have also taken place in the United States. In 1979 the Financial Accounting Standards Board issued *Statement of Financial Accounting Standards No. 33*, which requires large companies to publish both current-cost and purchasing-power-adjusted financial information. There are many similarities between current-cost requirements in the United Kingdom and the United States, but there are also some important differences.

In this edition the conceptual approach adopted in the first edition is retained. The conceptual nature of methods of accounting in an inflationary environment are described and illustrated. The concepts underlying *Statement of Standard Accounting Practice No. 16* and *Statement of Financial Accounting Standards No. 33* are discussed and related to other methods. In addition, the practical requirements of these standards are illustrated, and in an appendix to Chapter 6 a comprehensive example is used to compare them.

The difficulties of achieving agreement on standards for current-cost accounting reflect a general problem of *standard setting*. Many different, and possibly conflicting, views have to be taken into consideration. The standard setting process is becoming increasingly political, in the sense that the achievement of acceptable standards is 'the art of the possible'. The framework for accounting discussed in

Chapter 7 has been revised to reflect this political aspect of developing standards for financial reporting.

I am grateful to Alan Southworth for the benefit of his experience in using the first edition with students at Manchester University and for his comments on my revisions. However, I am entirely responsible for any errors which may remain. Finally, my thanks are again due to my wife, Maureen, for her continued encouragement and for typing the manuscript of this edition.

*Manchester University*  
*May 1980*

Robert W. Scapens