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Address Correspondence to
EDITOR-IN-CHIEF
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A DESIDERATUM: COMING TO TERMS WITH INFLATION ACCOUNTING

BY

OSAMUYIMEN EGBON
Department Of Accounting
University Of Benin Nigeria

SYLVESTER ERIABIE
Department Of Accounting
Benson Idahosa University Nigeria

ABSTRACT

Accounting mechanisms measure the well – offness or otherwise of economic units in response to environmental unfoldings to which it responds in order to be relevant in meeting users' economic decision needs. However, inflation remains a factor trifling the meaningfulness and relevance of HCA in meeting these needs. This paper attempts to look at the need to entrench a general price level accounting as a launch pad for developing general- specific price level changes in the future. Emphasis on the success of this drive revolves around a concert by relevant players.

This paper is divided into seven parts namely, (i) an overview of the utility of HCA in an inflationary environment, (ii) some criticisms of inflation approximations in HCA, (iii) A British inflation accounting trail, (iv) essential for inflation accounting incumbency on NASB, (v) the government and its expected role, and (vi) conclusion.

1. AN OVERVIEW OF THE UTILTY OF HISTORICAL COST ACCOUNTING IN AN INFLATIONARY ENVIRONMENT.

No gainsay that inflation is a growing syndrome ravaging economies of the world, especially developing nations. It is a phenomenon we live with daily and have to grapple with, because its spiral ripple on economic factor tends to parallel the rape of HIV / AIDS on human immune system. As economic factors are quantified in monetary terms, religious adherence to such nominal monetary measurement without reflecting the impact of inflation renders it largely unrealistic. The reporting of economic transactions for useful economic decision-making is the hallmark of accounting numbers, thus it is incumbent on accounting profession to "evolve and "adapt" a reporting basis that captures the impact of declining purchasing power, however crude.

A retrospective overview of the development of accounting would point us to the fact that financial reporting evolved from environmental unfoldings {Economic, political, legal, social and technological} which exert influence on it and on which it exerts influence, too {Anao, 1999:8; Glautier and Underdown, 1997:5-8, Belkaoui, 2000:3; Green, 1930:91; Ezejelue, 2001:320}. The influence tends to shape and reshape accounting information in a bid to making it relevant and reliable for economic decisions by the users thereof. The quest for reliability and objectivity has made historical cost accounting a contrived sacrosanct. This contrivance has been overprudently applied to the extent that it seems sacrilegious evolving, or even adopting another reporting paradigm in spite of new economic realities {particularly inflation} strewn across the globe.

In order to make accounting information situation-relevant, it must capture inflationary impact in tandem with historical reporting, where the latter is viewed for retention. To make this work, standards setters must work in concert with preparers of financial reports to allow for a standard on inflation accounting, no matter how crude. Very essential is a creeping evolution from historical cost accounting to an inflation accounting model that could easily be understood to a more sophisticated approach. Had the profession taken this stride since the recognition of the liquidation effect of inflation, perhaps, we would now have arrived at a concerted destination! This crude starting point is imperative contingent on the shortfall of historical accounting namely:

- Understatement of net assets.
- Understatement of depreciation and cost of sales with the attendant overstatement of profit.
- Overstatement of return on capital employed owing to the above illusions.
- Possible return of capital through dividend payment
- Possible excessive tax payment insinuated by overstatement of profit
- Meaninglessness of comparability {inter – firm and inter – temporal}
- Susceptibility to take – over bid
- Over-valuation of share price

The implicit recognition of these shortcomings gives management intuitive clues to provide approximations to cushion the adverse impact of inflation through:

- Periodic valuation of fixed assets
- Valuation of cost of sales using LIFO
- Provision for depreciation on replacement cost basis
- Reserve policy

However, these roundabout ways of whittling down the impact of inflation are fraught with problems. Despite these roundabout ways of making HCA seemingly adaptable to general price – level changes, Anao {2003} perceives HCA as an "*exercise in grand deception*". It thus implies that no matter the adjustment, insofar as it is still substantially historical, obviation of the hiatus created by HCA in reconciling price – level effects remains endemic to the relevance of financial reporting for making useful economic decisions.

II SOME CRITICISMS OF INFLATION APPROXIMATIONS IN HISTORICAL ACCOUNTING

1. **Periodic Valuation of Fixed Assets:** It is both cumbersome and costly to apply.
   Because it is not carried out yearly, there is also a distortion in the value of the assets in the intervening periods between two valuation dates. Besides the aforementioned, Ola {2001:4} believes that director could use it to sweeten equity by adopting shenanigans {window – dressing} strategy while planning to raise finance from the market because it is an arbitrary adjustment.
2. **Valuations of cost of sales at LIFO:** Though this will ably disentangle inflationary effect from gross profit contingent on charging the more current cost to cost of sales, the net assets are understated unless closing stock is adjusted to reflect current value in the balance sheet {Lewis & Pendrill, 1996:493}
3. **Depreciation provision on replacement cost basis:** This is riddled with problem where the particular assets does not have an identical replacement. Though the creation of reserve to take the excess depreciation over historical depreciation is prudent, subjectivity lies in the asset value. The use of this could only reduce the possibility of understatement of depreciation as a cost that should be recognized in the profit and loss account, but it does not remove the possibility of understatement of fixed assets in the balance sheet unless the value of the assets is written down at the value that corresponds to the estimated replacement cost upon which the imputed depreciation is based.
4. **Reserve policy:** The allowance for retention tends to obliterate the danger of return of capital, but it does not in any way preempt the overstatement of profit.

III INFLATION ACCOUNTING: A BRITISH HISTORICAL TRAIL

Accounting information is not an end in itself but a means to an end namely, enabling users to make useful economic decisions. Owing to this, inflation has been noted from the early 20th century as an encumbrance on realistic financial reporting information in sequel to adherence to historical accounting. The need for inflation accounting had long been recognized in the early 20th century {Sweeny, 1927}. An unprecedented inflation that ravaged the UK economy in the early 1970s instigated **ED 8** that birthed the provisional SSAP 7 in 1974 by Accounting Standards Steering Committee {ASSC}: Recommendation of Current purchasing Power Accounting {CPPA}.

The concern of the government in inflation accounting led to its inauguration of the Sandilands Committee whose report in 1975 recommended current cost accounting {CCA}. Though its proposal was approved in 1976, it received alarming spate of criticisms {Lewis and Pendrill 1996:438}. Over time, efforts made by UK's ASC to entrench inflation, or price level changes accounting {ED 18, ED 24, SSAP 16} have met with no success, hence the diminuendo could be attributable to two important factors namely, the convoluted nature of CCA, and to a lesser extent, the present low inflation rate in the UK. The X – ray of the British inflation accounting history is imperative because our accounting system is similar in many perspectives.

IV. ESSENTIAL FOR INFLATION ACCOUNTING

The essence of inflation accounting is the concept of capital maintenance. IASB framework {2001:P.105} recognizes capital maintenance as a linkage between the concepts of capital and concepts of profit. Three capital maintenance concepts are recognized in the NASB ED 22 {Financial Reporting in Inflationary Environment} namely, capital maintenance in:

- Monetary term
- Productive {physical } term
- Purchasing power tem

Historical cost accounting {HCA}, general purchasing power accounting {GPPA} and current cost accounting {CCA} permit capital maintenance in monetary, purchasing power and productive terms respectively.

A. Monetary capital is maintained if the nominal net assets value at the end of a period is more than that at the beginning. This is inundated with problems enumerated under the pit fall of HCA. Because net assets are understated, profit are overstated and hence the tendency of inadvertently returning some part of capital by way of dividend payment.

B. Productive capital maintenance seeks to maintain the same productive base or capacity at the end of a period as it was at the beginning. Current cost accounting seeks to maintain this variant of capital by the application of deprival value such as replacement cost {RC}, net realizable value {NRV} or present value {PV} according to the schema developed by Sandilands Committee as set out below:

Replacement Cost {RC}*

DEPRIVAL VALUE Is the lower of

And higher of

Present Value {PV}

Net Realizable Value {NRV}

Though the schema has intellectual configuration, its implementation could only be possible in a world of perfection, or near perfect information. Its underlying flummoxing nature has been its undoing in the UK since its pronouncement.

Besides the fact that the productive capital maintenance with its current cost accounting {CCA} surrogate appraise mechanic is not a true measure of inflationary impact {but specific price level changes}, its vitiation border on:

- There is no consensus among its advocates as to what is the core mechanistic presentation approaches namely, the variants in the scheme.
- Complexity of presentation on the part of preparers and the associated dysfunctionality in upholding the model.
- Cost of implementation
- Threat to users' understandability, which is a recognized quality of financial statements.

C. Purchasing power capital maintenance seeks to ensure that the net asset at the beginning is not greater than that at the end in purchasing power terms. It is a true measure of inflation. Though antagonists of this model may argue that there is nothing like general price index because inflation does not affect all individuals and entities in the same way, the composite consumers indexing recommended in NASB ED 22 is a good proxy for general applicability. The assertion by Baxter {1984] cited in Glautier and Underdown {1997:343} would help pauperize the antagonists' school of thought:

> *"Hitherto we have found little fault with statistical tables {e.g. of national income} in constant prices, we do not decry the indexing of tax allowances, most of us would accept indexed investment as a godsend. Admittedly the retail price index does not represent precisely the consumption patterns of wealthy shareholders, but the divergence dose not seem to be big. No system of inflation accounting will be perfect, and a correction of income by a general price index seems the least bad of the possibilities."*

Apart from the soothing acknowledgement of the utility of general indexing favour of general purchasing power accounting and its surrogate real capital maintenance paradigm, it wields a good trade – off between complexity and understandability due to its less complexity. Another seminal contribution by Baxter {1984:vii} cited in Ola {2001:23} would further illuminate the imperative of general purchasing power accounting:

> *"Probably the most important of the problem of principle is whether economic or physical growth should be looked on as income. Physical growth seems to be winning. To my mind, this is a pity. Accountants should have stuck longer to their original proposal... {CCP} approach. This is fairly simple and easy to understand and a more logical measure of income than its physical rival {CCA}. It would have made an excellent starting point for reform."*

In our opinion, specific price level changes accounting should be the ultimate focus of accounting profession, but inflation accounting should not be disengaged as the threshold. It is better to lean into the proximate darkness with a little glowing candlelight than the use of an imagined floodlight to leap into distant darkness. As we lean into the dark tunnel little by little with the candlelight {CPP we shall sooner see the end of the tunnel {sophisticated CCA} through consistent polishing of the prevailing or adapted CPP.

V. INCUBENCY ON NASB

By virtue of the power vested in the NASB for the issuance of accounting standards in Nigeria and the recent conferment on it to enforce the compliance, it should stride to translate its ED 22 into a reporting standard. This power is explicit in Schedule 2 Part 2 Section A Paragraph 14 of CAMA 1990: *"subject to paragraph 15 the amount to be included in respect of all items in company's financial statements shall be determined in accordance with GAAP, and with the standards laid down from time to time by the NASB"*

The power conferred on NASB by the National Assembly vide the NASB Acts, 2003 signed on 10th July 2003 conferred it with the following functions:

a. Develop and publish statements of accounting standards (SAS) to be observed in the preparation of financial statement.

b. Promote the general acceptance and adoption of such standards by preparer (your company accountant, directors and external auditors) and users of the financial statements.

c. Promote and enforce compliance with the standards developed or reviewed by the Board.

d. Receive, from time to time, the accounting standards developed, IN LINE WITH THE PREVALENT SOCIAL ECONOMIC AND POLITICAL ENVIRONMENT (emphasis ours)

e. Receive, from time to time, notice of non-compliance of the accounts with the standards from the preparer (with the lower), user, or auditor.

f. Receive copies of qualified audit report together with detailed explanation for such qualifications from auditors of the accounts, within a period of 60 days from the date of such qualification.

A scrutiny of function (d) above would suggest that the entrenchment of SAS on inflation accounting is an imperative. It would be a dereliction of duty should the NASB fail to be situation relevant on this wise.

Since there was no major opposition to the proposed standard at the public hearing of 12 November 2003 (Anao, 2003:15) the Board should expedite action in entrenching the standard. NASB should blaze the trail in inflation accounting in West Africa sub-region and Africa. As Nigeria is held in high esteem in the contemporary Africa in the context of human and technical skills, NASB should work in concert with the professional accounting bodies (ICAN and ANAN) to entrench this desideratum. Attempt to implicate the professional bodies into this crusade is imperative so that they can sensitize their members (in private and public practices) in sequel, because implementation lies with the preparers of financial statements.

The professional bodies should exercise their mandate to equip their members with the basic mechanics of implementing the standard before its effective date through seminars and workshops. This is important because one obvious reason why many accountants would not want to defer to this new project is unfamiliarity with its operationalization.

The Board should also make a frantic effort to sensitize the government on this project and the implication it might have on its tax policy so that the needed steps should be taken for its adaptation. It is incumbent on NASB to point government's attention to the social economic benefit of its proposed standard in line with the function conferred on it. The British government took it on itself to establish inflation accounting in the 1970s by setting up the sandilands Committee. But because of probable ineptitude and insouciance of the political players in Nigeria, attempt to wait for such an effort might remain a dream turned dissolution. This NASB has the onus to implicate the government since the government has mandated it with this function.

As the rationalization of the saying goes, ***"what is worth doing is worth doing now"*** so the implementation of inflation accounting in Nigeria is worth doing now.

V1. THE GOVERNMENT AND ITS EXPECTED ROLE

It will be a prevarication if the government is not implicated in this matter. The implication of the government is necessary so it could align its tax system with inflation accounting reporting in order not to encumber companies to pay tax out of capital. Failure of the tax regime to be amenable to inflation accounting would be at the expense of shareholders and fairness: it will be a case of robbing Peter to pay Paul. Involving government will leverage the project's benign attractiveness to companies executives rather than inciting their resistance. As the power wielded by NASB could be brandished to stifle resistance by companies, without the action to implicate government to give the necessary tax concession, management might begin to evolve shenanigans to sweeten accounts so as to keep up share prices and returns. Apart from a likely management discontentment, equity holders may opt for other investment securities consequent on a possible fall in returns and share prices. To this end, a concerted concessionary effort should be brought to bear by the various stakeholders in this crusade.

Before a sophisticated tax regime could be set up, at the inception, at least, emphasis should be given to cost of sales, capitalized cost and deferred incomes. Cost of sales should be taken as adjusted in GPPA. Capital allowance should be fully granted in the year of incurring capitalized cost (one-of concession) because the cost would not have suffered much inflationary loss. Any attempt to defer the capital allowance, irrespective of how accelerated it might be, would not produce a fair tax unless there is an indexing of the capital allowance. Adopting an indexing capital allowance may be so clumsy, so a one-off allowance in the year of incurrence is a good proxy to foster real capital maintenance paradigm.

Also, organizations do defer certain incomes. Since these incomes are not taxed until recognized in the income statement, it will result in payment of a low quality tax in respect of them in the future due to the effect of lower purchasing power. Such incomes should be taxed in the year cash is received whether earned or not provided earning them is probable in the future.

V11. CONCLUSION

Granted that Nigeria financial reporting system is favourably gravitated towards the British system, the UK financial reporting system could dispense with inflation accounting due to low inflation rate but similar contemplation would be suicidal for Nigeria with a higher inflation or higher cumulative inflation rates. Singular recognition of this fact is enough to spur the Nigeria Accounting Standards Board (NASB) to take the bull by the horn especially now that it has been empowered to enforce its standards. NASB should take cue from Brazil, Chile, and Argentina that adopted Current Purchasing power Accounting at their critical moments (Anao 2003:3; Ola 2001:20). We need not to wait for such a moment of precipice but act now to set the precedent for other Africa countries, as a crusade to foster continued harmonization with International Accounting Standards in their relevant entirety (Re: IAS 29).

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