The Continuing Relevance of Constant Dollar and Current Value Accounting

Stephen A. Zeff
Bala G. Dharan

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In the United States, the United Kingdom, Canada, Australia, and a few other countries, accounting standards on current value and/or constant dollar accounting were issued at the end of the 1970s, a decade of high inflation. Since then, because of the steep decline in the rate of inflation worldwide, the standards statements have been either made non-mandatory or withdrawn. Today, few companies provide readers of financial statements with an analysis of the impact of inflation or relative price changes on their statement of condition and results of operations. Such disclosures, however, continue to be relevant in any attempt to understand the results of enterprise.

Effects of Inflation

Even with a low annual rate of inflation of between 2% and 3%, constant dollar accounting (Current Purchasing Power accounting in the U.K.) has important applications. In the U.S., the Securities and Exchange Commission (SEC) requires registrant companies to provide 10-year sales and earnings summaries. The cumulative effect of ten years' inflation of, say, 3% per year is 34%, and the failure to deflate the 10-year summary, especially for sales, can yield a misleading picture of the trend.

For some years (until 1992), the U.K.-based British Petroleum Company PLC, one of the world's largest petroleum and petrochemical companies, included in its annual report a 5-year sales and earnings summary with data deflated by the U.K. retail price index. The table below shows the data from British Petroleum's 1992 annual report on inflation-adjusted sales turnover and dividend per share. It is evident that an increase of 35% in sales turnover from 1988 to 1992, as conventionally reported, is reduced to an increase of only 4% in inflation-adjusted sales. Similarly, while the conventionally reported dividend per share shows a steady increase from 1988 to 1991, it is virtually unchanged during these years when adjusted for inflation. These comparisons would have been even more stark with a 10-year comparison.

	1988	**1989**	**1990**	**1991**	**1992**
Sales turnover (☝ million)					
As reported	24,706	29,056	33,039	32,613	33,250
Adjusted for U.K. retail price index	32,009	34,933	36,288	33,834	33,250
Dividend per ordinary share					
As reported	13.50p	14.90p	16.05p	16.80p	10.50p
Adjusted for U.K. retail price index	17.49p	17.91p	17.63p	17.43p	10.50p
Average U.K. retail price index	106.9	115.2	126.1	133.5	138.5

Source: The British Petroleum Company PLC 1992 Annual Report and Accounts, p. 58.

Another important role that could be played by constant dollar accounting is the restatement of depreciation and amortization figures in the income statement, which refer to the purchase prices of depreciable assets or intangibles of 10, 20, or 30 years ago. These figures, reflecting prices paid in terms of general price levels prevailing many years ago, are being combined in an income statement with dollars or pounds of sales revenues and other expenses expressed in terms of the current year's much higher general price levels. To combine such figures in the same statement, without explicit recognition of the intervening years of inflation, produces results that are uninterpretable. For companies that have large amounts of long-lived fixed assets, such as in the airlines, hotel or chemical industries, adjustment of depreciation for rising prices is essential.

Companies that do not have large fixed assets are more likely to have large amounts of financial assets. For these companies, adjustment of gains and losses on financial instruments for the impact of inflation would be essential for proper interpretation of their results of operations. Especially for financial institutions, which have large amounts of long-term receivables and long-term payables, the inflation-related losses or gains that accrue on such financial instruments stretching over 10 or 20 years can be considerable, yet they are typically not disclosed in conventional financial statements.

Current Values

The importance of current values for financial analysis is undiminished even if the annual rate of inflation were zero. As the specific prices of goods and services change in relation to one another--a phenomenon that occurs in any healthy economy, with or without inflation--real gains and losses accrue to enterprises. In the U.S., until the last 20 years the SEC had prevented registrant companies from departing from historical cost accounting and disclosing current values, except where conservatism is served (as with "lower of cost or market" for inventories). But the SEC has become more open-minded in recent years, first with oil and gas accounting and later with "mark to market" accounting for marketable securities.

Recently, with the issuance of Statement No. 115, the Financial Accounting Standards Board

(FASB) has moved toward requiring current value accounting for certain marketable securities. In addition, the FASB's new disclosure requirements for risky financial instruments, contained in Statement Nos. 107 and 119, bring a measure of current value accounting for these items, at least in the footnotes. Complex financial instruments and derivatives cannot be understood without bringing current values into financial reports, and more and more current value information that is being required for inclusion in footnotes may one day be viewed as the core of the information that should appear in the body of the financial statements.

Finally, the FASB, in another recent initiative (Statement No. 121), has introduced current value accounting for at least some fixed assets by requiring the use of fair market value or discounted present value for the remeasurement of assets classified as value-impaired. However, Statement No. 121 applies only to impaired fixed assets. Current value reporting for other fixed assets is still unavailable in the U.S. By contrast, in the U.K., where many companies periodically revalue fixed assets in their balance sheets, the Accounting Standards Board (ASB) is encouraging a broader movement in the direction of current value accounting. In the exposure draft of its Statement of Principles for Financial Reporting, the ASB expressed the belief that "practice should develop by evolving in the direction of greater use of current values to the extent that this is consistent with the constraints of reliability and cost" (Chapter 5, para 5.38, November 1995).

The increase in the pace of mergers and acquisitions in recent years, and especially the large acquisition premiums over market values seen in these mergers, may be partly attributable to the absence of current value information in present financial statements. In the U.S., 1995 had the largest dollar volume of announced mergers and acquisitions, with an unprecedented $458 billion in deals, up 32% from the previous record of $347 billion in 1994. In the absence of publicly available current value information, investment bankers, managers and others with access to private information on current values are able to bid up the price of a company far above the market price. This is particularly true in the case of management-initiated buyout offers, as was common during the late 1980s. In the resulting merger or management buyout, assets are typically written up to market values, and/or large goodwill amounts are recognized, making public the previously private information on current values. This indicates that if accountants continue to fail to report current values in financial statements, then the financial markets will do the job for them by forcing the revaluation of assets to market values through the much more costly process of mergers and acquisitions. From an information economics perspective, it would seem to be more equitable and cheaper for accountants to provide current value data than for financial markets to obtain it through mergers and acquisitions.

Overall, the importance of current value accounting for proper measurement of various classes of financial and non-financial assets is being recognized, albeit slowly and indirectly, by standards setters. Managers, accounting practitioners, and educators should recognize this trend and take the lead in promoting the inclusion of more useful information in financial statements. Investors and financial markets seem to be saying that adoption of current value accounting should not be delayed until a recurrence of 10% or 15% annual inflation.