AN APPRAISAL OF CURRENT COST ACCOUNTING TECHNIQUES FOR ENHANCING MANAGERIAL DECISIONS IN CORPORATE MANAGEMENT

BY

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Abstract

The objective of this study was to assess the underlining issues pertaining the relevance or otherwise of historical cost in the preparation of financial statement of firms. It further seeks to explore other alternative methods of financial report in an inflationary environment. Secondary sources of data, such as text- books, journal articles and internet materials relevant to the study were consulted. The finding of the study revealed that, historical cost is deficient due to its inability to reflect the effect of changing prices. The study recommended the adoption of current cost or current purchasing power accounting as alternative method of financial reporting so as to ensure the relevance, reliability and usefulness of information in the financial statement of an enterprise.

Keywords: Current Cost Accounting, Financial Reporting, Nigeria

Introduction

According to Garba (2011) traditionally, accounts are prepared for two main reasons; stewardship and decision making. Therefore, financial statements are expected to be prepared in such a manner not to mislead users in making investment decisions. Furthermore, the ways and manner items of cost are measured in monetary terms for accounting purposes have tremendous bearing on the reliability, relevance and decision usefulness of the statement so produced. One of the criticisms of historical cost according to Wood and Sangster (2002) is its inability to reflect the effect of changing prices.

Valuation of items in the financial statement is normally made on historical cost convention since the codification of double entry by Luca Pacioli in Venice in1494 (Hendriksen and Breda 2001). This implies that, information on resources originally acquired or brought into business are reported on the historical cost basis of accounting without recourse to time and replacement cost of acquiring new asset. According to Kantudu and Saidu (2009) it was not until recently that, financial statements prepared using the historical cost basis were deemed to provide useful, relevant and reliable or even substantially adequate information to management and other users.

With the rising level of inflation which pervaded the world from the 1980s up till 2012 however, controversies were generated among scholars and criticisms by professional accounting bodies as regards the accuracy of financial statements so prepared on the basis of historical cost convention. The concern has been on how relevant is the value of items accounted for under the historical cost? There is no doubt of the negative impact and general and specific implications of inflation first on the purchasing power of money and on the value of asset held in consideration to current period. Thus, Meigs and Meigs (1984); Wolk, Tearney and Dodd (2003) and Nobes and Parker (2006) in Musa (2009) believe that, financial statements not adjusted for the effect of inflation often cause distortions in reported profits, asset values and liabilities.

Current cost accounting was an important issue in both the U.S. and the U.K. to the extent that, there was an accounting standard (FAS 33) and (SSAP 16) for US and UK respectively. These standards requires supplementary CCA disclosure to be made by large companies, but due to widespread non-compliance and in some instances outright rejection led to it being made non-mandatory in 1986 and eventual withdrawal by the UK Government in 1988 (Clayton and Blakes 1984).

Since the withdrawal of SSAP16 in the UK, financial accounting report has typically represented an uneasy mixture of historical and current cost values in line with the Accounting Standard Board, (1993a) and (1993b). Even after the withdrawal, companies that so wish, are still permitted to produce full CCA information.

The major aim of this paper is to examine current cost accounting as a better alternative to historical cost accounting.

Literature Review

Historical Cost Accounting (HCA)

Historical Cost Accounting (HCA) model has been a commonly used method of valuation in the traditional accounting practice; where items are valued in accordance with their cost of acquisition by firms (Glautier and Underdown 1988). Historical cost reports the asset and liabilities of an entity in the financial statement with their values as at the time of acquisition and not as per their current value. It therefore means that the monetary unit of measurement and the prices of goods and services remain stable over time. However, in real life situation, the value and price of monetary unit of measurement keep on changing every year (Garba 2011).

Principles of Historical Cost Accounting:

The accounting concepts, conventions, principles or the Generally Accepted Accounting Principles (GAAP), as they are usually called, favours the historical cost accounting (HCA), and for many years have dominated the way and manner in which financial statements are prepared in Nigeria and in other countries of the world. In other words, the existing postulations have dominated the understanding and thinking of managers, auditors and the regulatory agencies to such extent that any change or switch in method may be strongly resisted (Kantudu, 2003).

Merits and short comings of Historical Cost Accounting

The principle of conservatism has led the accounting profession to favor historical cost accounting in most instances. This is because; it is consistent with the fundamental accounting concepts of consistency, prudence, accrual and going concern. According to the ACCA(1982) in Wood and Sangster (2002), Historical Cost Accounting is objective in measurement as it is based on historical transactions, it is easy to understand and replicates easily recorded data, avoid subjective valuation of assets and enable share holders assess the success or failure of management in their role as stewards of the enterprises affairs. The method is subjective to some degree in for example, bad and doubtful debt provision and in the choice of depreciation method (Wood and Sangster, 2002).

Current Value Accounting (CVA)

The ACCA (1982) defines Current Value Accounting as an alternative accounting system which combines all the advantages of reporting with a realistic value of assets. Jennings (2004) asserted that current value accounting system measures assets and liabilities by reference to their value to the business.

Concept of Current Value Accounting

According to Mifflin (2010) current value accounting entails the preparation of financial reports by utilizing the current value rather than the historical cost of assets. Current value accounting attempts to provide more realistic book values by valuing assets at current replacement cost, rather than the amount actually paid for them. Thus, current cost otherwise known as fair value is a concept used in accounting and economics to mean a rational and unbiased estimate of the potential market price of good, service or asset taking such objective factors as acquisition, production, distribution and replacement costs and subjective factors such as risk, cost of and return on capital and utility as perceived by the individual.

Types of Current Value Accounting

There are principally three different types which are of common use today

a) Replacement cost. Also known as current entry cost or current entry value
b) Realisable values: This is otherwise known as current exit value and
c) Deprival value: This concept uses a mixture of realisable value, replacement cost and economic value.

These three methods share certain features i.e. they both recognize profit if realized, they use transaction based accounting and they use current values for asset recognition in the balance sheet of a Firm.

Advantages and Short comings of the CVA over HCA Method

The ACCA (1982) in Chambers (1986) the CVA has the following advantages

- It assigns a true value to assets
- It separates profits into its components i.e. operating, realized and unrealized holding gains. These provide users with adequate information of when, how and why profit has arisen. It also provides them with accounting information which enable them assert the economic viability of the company, vulnerability to merger, take over or liquidation.

As to the short comings however, the ACCA (1982) gave conceptual difficulty of accepting that, replacement cost should be applied to assets which may not be replaced at the end of their useful life, cost estimation being too subjective, and implementation of exit value being very difficult and many others.

Inflation and Current Value Accounting

A lot of attention has been given to Current value accounting by professionals as a result of price level changes and the problem of measuring a realistic figure of profit in periods of high inflation. Current value accounting is not a type of inflation accounting. However, it uses either an entry value or exit value and not the general inflation index which may bring about differences in prices (ACCA, 1982).

Current Purchasing Power Accounting (CPPA)

This is an adjusted historical cost concept where adjustments are made to historical cost values for changes in the purchasing power of money by means of consumer price index (Glautier and Underdown 1988). The CPPA identifies two types of price inflation i.e. specific and general price inflation. This type of accounting is based on the concept of capital maintenance as it measures profit as an increase in the current purchasing power of equity. This means in essence that, profits are stated after allowing for the declining purchasing power of money due to price changes or inflation. The idea of CPP is that, capital should be maintained in terms of the same monetary purchasing power. Under the CPP accounting, profits are measured after allowing for general price changes.

Statement of Standard Accounting Practice No. 7 (SSAP 7)

This is an accounting for changes in the purchasing power of money issued by accounting standard committee of UK (Chambers 1980). It is the legal bases of current purchasing power accounting which suggested that, a supplementary statement should be attached to financial reports of companies showing the conversion of the figures in the financial report in terms of their Current Purchasing Power (CPP) at the closing day of the accounting period. The statement recommended that, the Retail Price Index (RPI) should be used to effect the conversion of Historical Cost values into CPP equivalent (Glautier and under down 1988). SSAP 7 was later withdrawn in1978 due to some deficiencies; Nigeria does not have any standard with regards to CPP.

Advantages and short comings of CPP

The ACCA (1982) in Clayton and Blakes (1984) asserted that, CPP restates asset values in terms of stable money values, provides a more meaningful basis of comparing profits measured in" real" terms and excludes" inflation" value increments, it avoids subjective valuation of asset because a single price index is applied, it provides a stable monetary unit with which to value profit and capital. For the short comings however, the acronym NCCP is considered ambiguous by the professionals, it uses a generalized purchasing power as measured by consumer price, retail price or indeed any other price index which has no obvious practical significance (Kantudu& Saidu 2009 and Jennings 2004). Critics of the CPP argue that, the use of indices inevitably involves approximations in the measurement of value in CPP balance sheet which has less meaning than a current value balance sheet (Clayton & Blakes 1984).

Current Cost Accounting (CCA) and Financial Reporting

The CCA is a means of introducing current costs rather than historical costs in the preparation of financial statement. The SSAP 16 maintain that the historical cost account information should either present historical cost account as the main account with supplementary current cost account, present current cost account as main with supplementary historical cost account or present current cost account as the only account accompanied by adequate historical cost information (Clayton and Blakes 1984). Current cost is defined using Value to the business (VTB) method, replacement cost is defined as the cheapest replacement cost of new asset equivalent while recoverable amount is defined as the higher of net disposal or present value of the additional cash flow resulting from retention of the asset. The CCA uses the concept of capital maintenance for maintaining operating capacity which was approved by the Sandilands committee's report of 1975 (Wood and Sangster 2002).

The use of CCA was further supported by the Byatt Report (1986) in the context of regulating state-owned enterprises (Kantudu and Saidu, 2009).The report argued that, current cost represents the cost that would be incurred by a hypothetical new entrant to the business, while current operating profit represents the surplus that such an entrant could earn from operations and current cost of asset employed represents the cost of creating the business in a competitive market. However, a new entrant into the business would experience holding gains or losses due to changes in the price of assets between the time(s) of acquisition and use. This gain which should be added to current cost operating profit is known as comprehensive income. It is also employed in the assessment of returns to proprietors or in case of a firm, the share holders.

These gains are to be adjusted for the effects of inflation to measure real income (RI), (where real is used in the economist's sense). This real income according to Kantudu and Saidu (2009) is sometimes referred to as the real time accounting system.

In their study of CCA, Edwards, Kay and Maryer (1987) in Kantudu and Saidu (2009) advocated an accounting rate of return derived from the RI system in the appraisal of private sector enterprise performance. They based their argument on capital budgeting theory which compares the accounting rate of return with the cost of capital of the firm as a signal to a firm's profitability or otherwise.

Banking on the above arguments, some regulated utilities in the UK (e.g. British Gas Company) used the CCA in conjunction with estimates of the cost of capital as justification for their profit elements to be built into their price –cap formulae.

Research Methodology

This research is library based as scholarly journals, text books and internet materials were utilised in a thorough review of relevant existing literature on the subject.

Results and Discussion

It has been seen that, CCA became very much popular in the US and UK in the 80s especially by the issuance of SSAP 16 and its recommendation in the Sandilands report. However, many factors led to the discontinuation of the CCA practice.

According to Kantudu and Saidu (2009) it was discovered that, for a CCA to be widely applied, there was a need to set up a regulatory body that could ensure adequate compliance and control the rate of return by business organizations. This means that, the regular requires reliable information relating to prospective cash flow rather than a single bottom line profit number.

Secondly, the application of pure rate of return is a potential recipe for misdirecting managements effort and energy towards negotiating a higher regulatory asset base or higher permitted rate of return, or even for achieving a higher rate of return by greater efficiency or innovation in products and services to meet consumer needs. Thus, the efforts were always to make the CCA financial statement more attractive than the historical cost results. Doubts was however casted as to whether the value to the business (VTB) employed by the regulatory body is the appropriate valuation method for calculating a regulatory return for all enterprises.

Thirdly, the suggestion by Byatt Report (1986) and Edwards, Kay and Mayer (1987) on the rate of return based on real terms accounting provides a useful measure of economic returns for comparison with the real cost of capital. Furthermore, the regulatory practices of CCA in the UK have been a failure in that, they could not operate effectively. Thus, if what the regulatory body is supposed to achieve must be achieved in terms of strict compliance, then, the cost of such imposition may be so high, so much so that, it exceeds the non-numerical benefits needed in ensuring adequate disclosure of financial statements for better decision making.

Finally, according to Wood and Sangster (2002) the declining rate of inflation in UK since 1987 forces the loss of popularity of the CCA. Hence, continuation of the concept may no longer be justifiable. However, the high rate or even the galloping inflation experience in developing countries (Nigeria inclusive) made the CCA application hypothetically more appropriate. But, the contentious issue still remains as to how much is the cost of operating and sustaining the policy and how credible is financial reporting in general under the CCA convention?

Conclusion and Recommendation

From the foregoing, it is clear that, the CCA application in the US and UK has failed even with its numerous advantages over historical cost accounting. Musa (2009) and Kantudu and Saidu (2009) assert that, the CCA posses a lot of practical application bordering on objectivity and personal integrity of the regulator. It is therefore recommended that, a systematized valuation method to include current values especially on a value to the business basis should be pursued.

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