



CURRENT VALUE ACCOUNTING -- WHAT'S IN IT FOR YOU

If you were asked to select those business-related professions, which, in your judgment, were most inclined toward continuous change, what would your answer be? Perhaps your selection would include the legal profession, industrial engineering, finance, or even electronic data processing. It is most unlikely that your selection would include the fields of accounting and economics. Each of these latter two professions is generally characterized as being somewhat staid, steeped in tradition, and conducted within a strict discipline of historical sanctions.

In brief, neither profession conveys to the average businessman a great deal of romance or dynamism. Yet economics and accounting, or more precisely, the impact of economics on accounting, comprise one of the most fundamental change -- inducing elements affecting American business in recent years. It is called current value accounting, and in the months and years ahead, few businessmen will escape its prospects, problems, and attributes. This paper will only scratch the surface of this rather complex concept. The following discussion cannot hope to deal adequately with each of its components. I hope that it will provide for the agribusiness manager a greater appreciation of the evolution, potential, and adaptability of current value accounting as it relates to his own firm and current accounting practices.

Background

The many goals of accounting converge into an attempt to measure, record, and communicate the economic realities of a firm's activity. Traditionally, this has involved the compilation and preparation of a regular series of financial statements or annual reports based on the concept of "historical costs." More specifically, the recording function has been linked to the cost documentation of assets employed, resources purchased, and/or services secured as were historically incurred.

This concept proved quite adequate insofar as there existed relative stability in our economy and small adjustments in resource price levels between fiscal periods. However, something strange and unforeseen began to happen in 1973. Throughout the agribusiness industry (and other sectors of our economy) resource price levels began to rise at an accelerating rate. By 1974, we were in the midst of the most damaging inflationary period of this century. By year-end, 1974, prices throughout the agribusiness industry were rising at an annual rate of 12 to 16 percent. Before long, the economic realities of this price spiral became evident.

Using their traditional tools, methods, and concepts, the accountants were unable to accurately depict the true economic vitality of the firm. A quick check of the record reveals that agribusiness profit levels suffered little during this period. However, the astute manager and the accountants knew better. Despite what was shown on the bottom line, this villainous inflation had dealt a staggering

blow to the health of the industry. For example, corporate after-tax profits within the U.S. grew from \$38 billion in 1965 to \$66 billion in 1974, an increase of 74 percent; but this increase was largely illusory. If we were to adjust for the two major inflationary factors (under depreciation and inventory profits), after-tax corporate profits actually declined from an adjusted \$37 billion in 1965 to \$21 billion in 1974.

The Problem of Illusion

In fact, inflation had injected a significant illusory element into the well-intentioned efforts of the accountants.

Such illusions occurred in the form of "inventory profits" resulting from price increases overstating earnings because such profits soon evaporated when the cash generated through sales was used to replenish inventory purchased at inflated prices. The agribusiness retailer of farm supplies and machinery can well recall this phenomenon. He entered 1974 with inventories purchased at earlier cost levels. These supplies were later sold at inflated retail prices and profits grew accordingly. In some cases, for example, fertilizer retailers realized greater book gains from the storage of materials during this period than they would have realized from the actual sale of those materials at the traditional cost-plus level, retail. In brief, the warehouse was proving more valuable to the farm supply retailer than his cash register and checkout sales counter. Yet before long, inventories had to be replenished and at prices, which had a real sobering effect on the manager who was, basking under the illusion of his earlier earnings' statements.

Illusions also occurred in the form of "under depreciation" where companies had to spend more (much more than the book depreciation suggests) to replace worn out machinery and equipment just to maintain the same level of operations. The grain and

food storage industries, for example, quickly discovered that existing depreciation sums were woefully inadequate to finance the purchase of replacement warehouses. Again cash profits, as recorded by the accountants, proved to be illusory and short-lived.

Moreover this massive and continuing inflation had come at a time when the capital needs of agribusiness required rapid expansion to 1) fill the needs of an expanding production agriculture, 2) meet recently imposed environmental and safety constraints, and 3) secure alternative sources of energy and raw materials. This was in addition to the demands for capital to replenish inventories and replace productive assets such as machinery and equipment at inflated costs. Efforts to meet these extraordinary demands for capital forced many companies to overextended debt positions.

Other Distortions

There is no question that inflation created illusory profits throughout the agribusiness industry, and that accountants were ill prepared to depict this influence in their recording efforts. As a result of illusory profits, other distortions soon became evident. Income taxes, for example, are based on reported earnings. Hence, taxes are levied against earnings and against capital disposition. Corporate stockholders, of course, expect greater dividends based on profit levels they fail to recognize as illusory. Before long the unions are encouraged to ask for increases in wages and benefits. Even the general public may begin to challenge the credibility of an industry, which pleads a capital shortage or a liquidity problem at the same time its annual earnings have reached a record level.

Secretary of the Treasury, William E. Simon, recognized the problem by stating before the House Ways and Means Committee in 1975:

“...the general decline in real corporate profits is the most fundamental trend which should be reversed. A good part of the erosion in profits in recent years has been concealed by what might be called ‘public relations bookkeeping.’ It has been hidden from shareholders and often from management itself by accounting practices which in times of major inflation fail miserably to reflect real earnings.”

What Can Be Done?

The effects of inflation, even at its currently more modest level, have clearly shown the inadequacies of historical-cost-basis accounting. In truth, accountants have long been aware of its weaknesses. Yet not until recently has the profession expressed a willingness to devote the efforts required to develop a suitable alternative. And their star now shines brightly as current value accounting (CVA) is now being proposed by many accounting firms as the most desired solution. Surprisingly, the basic concept of CVA is not truly unique and has been used by economists and those in the financial community for many years. The concept suggests simply that the actual cost of an asset or resource is a very poor measure of its true “worth” in inflationary times. Instead, the true worth of that asset, its present value, is a function of the future revenues and financial obligations to be generated by that asset, discounted back to the current fiscal period. True profits, of course, exist to the extent that the current fiscal value of revenues generated exceeds the current value of financial obligations incurred from the assets’ employment.

Conventional financial reporting, of course, is focused on the classification and reporting of a firm’s assets, liabilities, net worth, income, expenses, and earnings. The basic format from within which these elements arise has changed very little in recent years. Under CVA the emphasis is changed from assets to a reporting of “economic resources.” Liabilities

are replaced with a broader concern for “economic obligations” and instead of conventional profit and loss classifications, a broader concept of “net results of operations” and “changes in value” is considered. As proposed, the firm’s resources and obligations will be reported at current value; but because of measurement difficulties, the following three alternative means for determining current value are being advocated: 1) current cost, 2) net realizable value, and 3) present value. It is generally agreed that present value is the ideal basis for current valuation of resources and obligations because it is more consistent with management’s objective to measure future cash flows.

Except for direct-flow monetary items, however, this ideal is difficult to achieve in a practical sense, and the remaining two alternatives must be used. Each is discussed below.

Measuring Current Value

As noted, present value is the accountant’s preferred choice of the three measuring alternatives. Present value (of future cash flows) may be applied to an individual resource or obligation or to a group of resources and obligations. In all cases, it relates to future cash inflows and outflows that can be attributed to or related to a specific item or group of items. This measurement is particularly suitable to monetary items such as accounts receivable, notes payable, etc., where the timing of cash movements is quantifiable. In present value determination, an interest rate (or discount factor) is used to discount the future cash flows to the date of measurement. The discount factor, of course, refers to a rate considered appropriate to depict the current time value of money. Economists refer to this as the opportunity cost of cash flow, not to be incurred until some future time. The rate includes pure interest plus an allowance for risk inherent in the items being measured

and need not be tied to a contractual rate. For example, in measuring a note receivable, the rate may well exceed the contractual rate of interest and no distinction is made in the measurement of interest and principal inflow from that asset.

However, of course, for assets, which generate no clearly determined stream-of-future cash flows, the present value computation becomes inoperable. Such complexities may result from subjectivity, the simple lack of cash flow data, or complex interdependencies among several resources and obligations that make it impossible to attribute cash flows to specific items. Under these circumstances, current cost may be the preferred measurement alternative. Current cost means the cost of replacing the resource or obligation at the date the measurement is conducted. One may wish to judge current cost on the basis of the exact physical reproduction of the facility being measured. Alternatively, one may wish to rest this judgment on the replacement of equivalent capacity in current technology. If an agribusiness firm is heavily dependent on a technological base (food processors, for example) this latter method would be preferred. Regardless, appropriate provisions for wear, tear, and obsolescence must be made.

If neither of these two methods appears practical, the net realizable value is to be selected. Net realizable value might more appropriately be called "exit value" in that it represents an expected selling value after an allowance for appropriate carrying and disposal costs including such items as income taxes and interest.

Monetary vs. Non-monetary

As the previous discussion would suggest, the selection of current value measurement methods rests on the degree to which a resource or obligation can be monetized. Monetary items are those normally expected

to be settled by payments in specific cash amounts; all other items are non-monetary and include such things as property, plant, inventories, equipment, and intangibles. For the monetary items, it is often possible to directly compute present value where it is reasonable the contract will be fulfilled. For non-monetary items, net realizable value or current cost must be used. For illustration purposes, the following non-monetary items are listed with suggested procedures for current value determination.

Inventories. Ideally the determination of the present value of inventories would suggest the determination of eventual selling price offset by any completion cost, selling cost, and risk associated with final disposition. Insofar as this latter represents a significant imponderable, current replacement cost might be the most practical measure; i.e., the difference between current cost and selling price of inventories is assumed to compensate for the risk of final disposition. It is interesting to note that the conventional debate over LIFO (Last In First Out) and FIFO (First In First Out) valuations is eliminated under this new accounting procedure because all inventories at time of measurement are calculated at current value, regardless of when they were acquired. Cost flow assumptions for those agribusiness firms with seasonally large inventories (e.g., grain storage elevators) become substantially less formidable under this system.

Investments. Rarely do agribusiness firms carry large public investment categories within their balance sheet. Yet where investments in equity securities do exist, net realizable value based on quoted market or nearest approximation seems most appropriate. For cooperative agribusiness firms, of course, this represents a major problem insofar as equity claims are often not negotiable and rarely traded. More will be said of this and other difficulties later.

Land and nonrenewable resources. These resources are unique in that they often cannot be physically reproduced. Hence, current cost does not become a practical alternative and one must settle with net realizable value, unless, of course, some measure of economic value is reached.

Intangible. Again, agribusiness firms rarely carry valuations for such items as copyrights, franchises, and patents. Yet some firms with favorable long-term contracts for energy supplies may capitalize their value here. It appears that net realizable value would be the most appropriate measure. Conceptually, goodwill represents the excess of the present value of all cash flows for a business over the present value of the business entity generating that flow. CVA is not designed to portray the value of a business as an entity. Hence, goodwill may not be included in current value computations.

Adapting CVA

In the chance that CVA appears intuitively attractive to your managerial pleasures, what should you do? First, schedule a visit with your firm's accountant. This paper is woefully inadequate as a basis for your decision to select CVA. Most major accounting firms are now "gearing up" illustrative and educational CVA programs for presentation to their clientele. They should be better equipped to deal with the complexities of CVA as it might apply to the particulars of your agribusiness firm.

You would naturally express a concern for the cost of implementing and adapting to CVA. Obviously the costs will vary considerably, depending upon the amount of detail and degree of accuracy required. Changing accounting systems is always a costly adventure and the decision should be made only after a full review of benefits and costs has been completed by you or perhaps an independent consultant.

The conversion to CVA will most likely not occur in one all-encompassing phase. Moreover, it will most likely take several progressive steps. A first step may be the disclosure of the effects of CVA on the valuation of inventories, plant, and equipment. Concomitant to this consideration will be a study of the impact on cost of sales and depreciation schedules. Normally these data would be provided simultaneously with the conventional financial statements. This step is designed to give management and directors an opportunity to judge the new system on the basis of its preliminary impact. A second step would likely involve the preparation of a supplementary set of financial statements designed to describe CVA valuations for major monetary resources and obligations. A third step might require the preparation of a complete set of CVA-based financial statements. Next, the firm would have to establish a set of standards or guidelines upon which all future CVA computations would be based. By this time, historical cost statements are fulfilling a subsidiary role, but not totally eliminated. Finally, of course, the adoption decision must be made.

Potential Complications

As was discussed, the present value method of current value determination is preferred whenever conditions permit its use. The discounting procedure is not difficult to follow, nor is it difficult to support for purposes of argumentation or an IRS defense. Yet, selecting the actual discount rate to be used is not a well-defined process. Moreover, its selection may vary from year to year -- contributing toward confusion and a challenge by the IRS. At a minimum, it could be said that management would not select a rate less than the current rate of inflation, i.e., the economy, itself, supplants management in the establishment of a minimum rate. Neither would it seem reasonable for management to select a discount rate below

the contract rate on a resource or obligation, i.e., to do so would be equivalent to an admission that you are paying for long-term financing at a rate in excess of the rate at which those funds are being profitably employed within the firm (inverse financial leverage). Now this creates no great problem so long as the rate of inflation exceeds the average of the firm's contract rates. If, however, the annual rate of inflation drops well below this level, and the firm selects a discount rate in excess of their contract rate, substantial questions of justification do arise.

CVA creates some unique complications for cooperative agribusiness firms. Under conventional procedures, retained patronage is classified as equity in ignorance of any future obligations (or implications) that these monies are to be revolved. Under the CVA concept, accountants could less afford to ignore the potential of a cash outflow at some time in the future; i.e., they would be more likely to enter a present value consideration of a future capital revolve. In addition, as noted, cooperative capital stock is normally carried at face certificate value, is rarely traded, and does not warrant an open market quote. Now suppose cooperative "A" carries, as an investment, stock in a large regional cooperative "B." Under conventional practice, this investment appears on A's record at face certificate value. Under CVA, this investment (generally non-interest-bearing) would be entered at its discounted net present value. Depending on the length of B's capital revolving cycle, the CVA value could be only a fraction of that shown under conventional methods.

Hence, for cooperatives, in particular, the benefits inherent within CVA must be judged in light of these and other complications.

SUMMARY

Inflation of the magnitude experienced in this country in recent years (1972-1976)

awakened accountants to the inadequacies of their conventional methods. The realities of economic activities reduced the accuracy of conventional financial reports. Illusions arose such that management, stockholders, and the general public were no longer being adequately served. Current value accounting is now being proposed as a partial solution to such illusory reporting. The basic elements of CVA are as follows:

- 1. The goal of financial reporting should be to present the economic realities of a firm's activity, including such information which will enable management to better deal with inflationary pressures.*
- 2. Financial reports should depict economic resources and obligations as measured in present value wherever possible.*
- 3. The statements of financial condition should depict an inventory of resources and obligations measured in current values. Present value would seem most appropriate for measuring monetary items. Current cost may be appropriate for inventories and depreciable items. Net realizable value may be selected to measure all other non-monetary resources and obligations.*

Agribusiness managers should be aware of this proposed accounting procedure during times of high inflation. A detailed analysis of its attributes and complication must precede its selection. Further discussions with their accountants must precede its adoption.

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