Chapter 22

THEORETICAL MATTERS

- profit is the difference between an entity's capital at the beginning and the end of an accounting period
- but capital could be "financial" or "operating"
- financial capital is the aggregation of shares and reserves and is known as shareholders' funds
- objective of financial capital maintenance is to maintain shareholders' wealth
- operating capital (or physical capital) is the aggregation of non-current assets, inventories and monetary working capital
- objective of operating capital maintenance is to maintain operating capacity of the entity
- in achieving this, specific price changes are taken into account
- different accounting principles apply to different concepts
    - financial capital maintenance uses either nominal dollars or current purchasing power as the unit of measurement
    - operating capital maintenance uses nominal dollars
- how these possibilities combine can be summarised in the following table:

concept	*unit of measurement*	*assets valuation*	*system of accounting*
financial	cpp	historic cost	cpp
financial	nominal	historic cost	hca
operating	nominal	current cost	cca

Current purchasing power (cpp)

- some (or all!) of the items in the financial statements are restated for changes in general price levels compared with a stable monetary unit – the cpp
- changes in purchasing power are based on general level of inflation using the RPI
- cpp measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the fall in purchasing power resulting from inflation
- **effect on financial statement items**
    - monetary items and assets / liabilities fixed in $ terms by contract or statute?
    - adjustment is made to reflect fall in value if using cpp but no adjustment is made when using historic cost accounting
    - non-monetary items not fixed in $ terms by contract or statute? Adjustment is made to reflect change in value
- monetary items – value falls as inflation decreases purchasing power
- non-monetary items – value increases

Advantages and disadvantages of cpp

- **advantages:**
    - greater comparability resulting from asset value restatement
    - year by year comparisons have greater validity
    - subjectivity of other value measurement systems is avoided
    - being based on historic cost, as adjusted for indexation, the figures are auditable
    - gains and losses resulting from inflation are high-lighted
- **disadvantages**
    - use of indices necessarily involves approximation
    - what use are financial statements to a reader – majority rarely understand the figures even when based on the solid ground of historic costs
    - restatement of asset values represents neither value to business nor value realised – so no improvement on historic cost method

Current cost accounting (cca)

- cca is the system of accounting applied to the concept of operating capital maintenance

- the value of assets consumed or sold, and those in the statement of financial position are stated at their value to the entity

- value to the entity is known as deprival value

- deprival value is

lower of

replacement cost (rc) | higher of

net realisable value (nrv) | present value (pv)

- depreciation is charged on the asset based on gross replacement cost where replacement cost is the deprival value

- where nrv or pv is the deprival value, the charge against cca profits will be the loss of value of the asset

- goods sold are charged at their replacement cost. For example, an item of inventory which costs $25 is sold for $32 by which time its replacement cost has risen to $28

- **cca trading account would show:**

revenue	32
replacement cost of goods sold	(28)
current cost profit	4

Advantages and disadvantages of cca and disclosures

- **advantages:**
  - better assessment of stability, vulnerability, liquidity and future prospects
  - as a result of eliminating holding gains, there's a better indication of whether dividends will reduce operating capacity

- **disadvantages:**
  - finding suitable indices could be a problem
  - determining nrv and pv could be a problem

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