CHAPTER 7
INFLATION ACCOUNTING: RETROSPECT AND PROSPECT

by Charles Kennedy*

Outline of the debate

An interest in inflation accounting goes back at least as far as the time of the Weimar Republic, but in this historical outline I shall be concerned with the more recent debate in the United Kingdom. Even in the (by recent standards) moderate conditions of inflation in the sixties, there was growing concern at the distorting effects of inflation on company accounts when these had been prepared on conventional historic-cost lines. In the case of fixed assets, depreciation provisions based on the historic cost of the assets failed to ensure that capital was being maintained intact in real terms. In the case of stocks, the FIFO convention had the result that a substantial part of reported profits represented stock appreciation, even though such profits were of no real benefit to an on-going company which was having to replace its stocks at higher prices because of inflation.

The initiative in tackling this problem was taken by the accounting bodies. After the publication of a number of discussion papers, the Accounting Standards Steering Committee (ASSC) published an Exposure Draft (ED8) in January 1973, followed by a provisional Statement of Standard Accounting Practice (SSAP7) based on ED8 in May 1974. The standard was made provisional because in the meantime the government had in January 1974 set up its own Committee of Enquiry into inflation accounting under the chairmanship of Sir Francis Sandilands.

The accountants' proposals in ED8 and SSAP7 were relatively simple and amounted to a form of indexation. The main accounts were still to be presented on a historic-cost basis, but in a supplementary statement these historic-cost accounts were to be converted into units of current purchasing power at the end of the accounting period, by applying the change in the retail price index to earlier figures in the accounts.

The whole system came to be known as CPP accounting. The CPP adjustments were to be made not only to payments and receipts during the course of the period, but also to the figures in the opening balance sheet. This had an important consequence in the case of monetary items in the balance sheet. Since the monetary value of these would not have changed over the course of the period, a loss would have to be shown in the profit-and-loss account in the case of monetary assets and a gain in the case of monetary liabilities.

Although CPP accounting attracted considerable support, it also came in for criticism on two main counts. In the first place, it was argued that the use of a general index of inflation like the retail price index could fail to reflect the experience of actual companies which were faced with specific changes in the cost of their inputs. In the second place, it was held to be quite unsafe to take credit for the gain from monetary liabilities independently of the use to which the borrowing had been put, since the gain could turn out to be illusory.

Meanwhile, events themselves were taking a hand. The year 1974 witnessed a very sharp acceleration in inflation, with emphasis on rises in input prices rather than output prices, since rises in the latter were restrained by the operation of the Price Code. As a result, British industry was running rapidly into a cash crisis of alarming proportions. Historic-cost profits remained buoyant because of the large element of stock appreciation, and the Chancellor, obviously unaware of the true situation, aggravated matters by actually increasing the taxation of companies in the Spring Budget. Nor was the position of industry made any easier by the collapse of financial markets. New equity capital was virtually impossible to raise, and borrowing was made difficult because the banks were adopting a cautious stance following the excesses of the earlier property boom and secondary banking expansion.

Much of the credit for the early recognition of the crisis, and for drawing it to the attention of the public, must go to Professor Merrett and Mr Sykes. A number of early warnings culminated in their famous article in the *Financial Times* of 30 September 1974, which described the workings of a Doomsday machine. Unless policies were changed, the authors argued, British industry was doomed. The increased cost of replacing assets by on-going companies was being treated as a profit instead of as a cost, and these 'wholly fictitious' profits were being taxed as though they were genuine. At the same time, companies were facing an 'immense increase in interest charges resulting both from higher interest rates and additional interest on the extra moneys required to finance working capital and fixed investment under inflation'.

Merrett and Sykes had a strong case, but they had overstated it by introducing an element of double-counting. To the extent that the increased cost of

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replacing assets was being financed by new borrowing, it could not at the same time be a charge against shareholders' funds. Thus, it was illegitimate to argue that interest payments, as well as the whole of the increased cost of replacing assets, should be deducted from conventional profits. An early challenge to the Merrett-and-Sykes thesis was made in a paper by Wynne Godley and Adrian Wood, 'Stock appreciation and the crisis of British industry', published by the Department of Applied Economics at Cambridge at the end of October 1974. The authors used a model in which stocks were entirely financed by borrowing. In that case, they argued, accounting profit incorporating stock appreciation was both a true measure of profit and a proper basis for taxation.

The analysis was valid on the basis of the assumptions made, but the assumptions themselves, although explicit, were extreme ones. In an article in the *Observer* of 3 November 1974, Professor Alan Day was not slow to point out that the matter would be quite different if instead stocks were wholly financed from shareholders' funds. In that case, stock appreciation should not be considered a part of profit and should be exempt from tax. The argument was not at the time pressed home to its rather obvious logical conclusion, but there is little doubt that this particular exchange had an important influence on later developments.

In the event, Merrett and Sykes were persuasive in the matter of company taxation. In the special measures of November 1974, the Chancellor gave very substantial tax relief to companies whose stocks were increasing in value. The tax was deferred and not remitted altogether, but since the crisis had been one of liquidity, this was not a matter of immediate concern. With the passing of the November measures, the cash crisis of British industry was virtually over. Not so, the debate on inflation accounting!

The Sandilands Committee did their work with commendable despatch, and a unanimous Report (Cmd. 6225, HMSO) was published in September 1975. Even critics of the Report's recommendations will readily admit the valuable contribution made by the Committee in presenting and analysing the main issues. Indeed the Report became the focus for later discussions. In it, the Committee recommended a form of value accounting known as current cost accounting (CCA). Assets were to be systematically revalued in the balance sheet to reflect their 'value to the business' or 'deprival value', which in effect meant either replacement cost or economic value, whichever was the lower[1]. In the profit-and-loss account inputs were to be valued also at their 'value to the business', or current cost at the time of the sale of the output. To achieve this, two adjustments were necessary to the historic-cost profit figures: a depreciation adjustment so that depreciation provisions would be based on current cost rather than historic-cost, and a 'cost-of-sales' adjustment roughly equivalent to deducting stock appreciation. In paragraph 535, the Committee claimed in bold type that, so far as the profit-and-loss account was concerned, these two adjustments, and these two alone, would constitute a 'comprehensive system of accounting for inflation'. The effect of the proposals was to split the total monetary gains of a company during the accounting period into two components: operating profits, which alone were to appear in the profit-and-loss account, and holding gains, which were to be taken straight to reserves.

No special treatment of any kind was to be given to monetary liabilities and assets. Since these also were to be valued at their 'value to the business', which in their case would be their monetary value, no gain or loss on them could arise. Interest payments were nevertheless to be a charge against operating profit, so as to arrive at what can best be called 'Sandilands profit' (although the Committee continued themselves to use the term 'operating profit').

In their terms of reference, the Committee had been asked to consider the CPP proposals, and they were severe in their criticism of them. One complaint was that SSAP7 was proposing the use of a new unit of measurement, the unit of current purchasing power, whereas the Committee themselves argued in favour of the retention of the monetary unit. Since the unit of current purchasing power is currently a Pound, I have never myself been able to attach any great significance to this distinction. A more substantial criticism was concerned with the use in CPP of a general index of inflation like the retail price index. The Committee argued with some force that what companies were interested in was not the rise in prices in general, to which in any case the Committee were unable to give any precise meaning, but rather the price changes relating to their specific inputs, since it would be these that would affect their cash flow.

Adherents of CPP have accused the Committee of undue dogmatism and even pedantry on this issue. While the use of specific price changes, or of specific indices of price change, may be appropriate for some purposes, for example in the revaluation of assets in the balance sheet, for other purposes, for example for showing the inflation-corrected gain in the shareholders' interest in the income statement, the use of a general index would be preferable.[2]

The Committee's purist attitude to the problem of measuring inflation had a curious consequence. It led to a widely held view that the Sandilands proposals, far from constituting a comprehensive system of accounting for inflation, were not about inflation accounting at all. But the really interesting thing about this view is that it has not been confined to critics of the Report - snipers from the CPP citadel like Professor D.R. Myddleton[3]. Even staunch supporters like Professor Merrett and Mr Sykes *(Financial Times,* 15 October 1975) have argued that the Report was not trying to identify a measure of *real* profit, but rather a *realistic* measure of money profit. Once started on this semantic slide, it is only too easy to find oneself landing up in the absurd posture of maintaining that a current-cost rate of profit is somehow comparable with a money rate of interest. This is certainly wrong. Current cost accounting is a method of correcting for price changes, and any comparison of a current-cost rate of profit with a money rate of interest is manifestly illegitimate.

[1] There has been a good deal of discussion of the Sandilands approach to the valuation of assets, which I shall not attempt to cover here.

[2] See, for example, W. T. Baxter in the *Journal of Business Finance and Accounting*, Spring 1976, an issue of the journal that contains a useful collection of papers on the whole subject.

[3] See his paper in the same number of the *JBFA*, Spring 1976, as well as a number of letters to *The Times* and the *Financial Times*.

As in the case of SSAP7, the main debate on the Sandilands Report centred on the treatment of monetary assets and liabilities. That treatment, or rather non-treatment, seemed to follow logically from the principles the Committee had established earlier, but the principles themselves were insufficiently general, since they had been derived from an analysis in Chapter 4 of the Report of different concepts of profit relating to a hypothetical company that was entirely financed from shareholders' funds. This line of criticism was developed in an article in *The Times* of 1 October 1975 by Wynne Godley and Francis Cripps, who also proposed a solution to the problem of monetary liabilities.

The solution was in fact the logical outcome of the earlier exchange between Godley and Wood and Professor Day. If a company was partly financed by borrowing, not all holding gains needed to be stripped from profits along Sandilands lines but only a proportion of them, the proportion relating to assets financed from shareholders' funds. The geared gains, on the other hand, could be brought back into profit and were in principle distributable to shareholders. New borrowing would be required for the purpose, but even if the whole of the geared gains was distributed, the company's gearing ratio would be simply maintained and not increased.

The geared gains proposal has been supported by the present writer [4] and also notably by Mr Martin Gibbs of Messrs Phillips and Drew.[5] It has also been recommended in the Report of the Richardson Committee to the New Zealand government. It has come under criticism for assuming the existing level of gearing to be 'right'. This is a travesty. No supporter of the geared gains proposal has ever assumed the existing level of gearing to be right. All that is done is to take the level of gearing in the opening balance sheet as a point of departure for the purpose of measuring profit. In the adoption of this procedure, no new principle of any kind is being invoked. It has always been the case that the facts of the opening balance sheet have been taken as a point of departure for the measurement of profit. Moreover, it is clear that it is not the absolute value of the liabilities in the balance sheet that is of significance, but rather their value in relation to the value of the company's assets, the company's gearing ratio. The Sandilands proposals for measuring profit also took the facts of the opening balance sheet as a point of departure, but assumed instead the maintenance of the absolute value of monetary liabilities, a figure of no significance whatsoever when asset values are changing. The Godley–Cripps approach to monetary liabilities is definitely superior to the Sandilands approach.

In the same article, Godley and Cripps made the point that their proposal was fully consistent with a CPP calculation of the gain on monetary liabilities, and in fact embraced the latter. The point did not perhaps emerge very clearly from a rather complicated numerical example, but the principle is a simple one. So long as the asset in question is revalued at current cost at the end of the accounting period, a CPP calculation of the real gain on an asset financed by borrowing will always be identical with the monetary holding gain on the asset, *whatever may have been the change in the retail price index during the period.* This is because equal but opposite CPP adjustments will be made to the sum borrowed and to the historic cost of the asset financed by the loan. The two adjustments will therefore cancel each other, and we shall be left with the holding gain on the asset itself.

The Godley–Cripps proposal not only results in an acceptable measure of proprietary profits for a company partly financed by borrowing. It also effectively synthesises two quite separate strands of thinking: on the one hand the CCA idea that non-monetary assets should be systematically revalued at their current cost and on the other the CPP insistence that there is a gain to be had from monetary liabilities at a time of rising prices. Moreover, it incorporates the figure for the gain from monetary liabilities in a way that renders it immune from some of the earlier criticisms. As we have already noted, one of the main criticisms of the original CPP treatment of monetary liabilities was that credit was taken for the gain on them quite independently of the use to which the borrowing had been put. The geared gains approach sidesteps this objection by linking the gain on the liability to the holding gain on the asset. This has the added advantage that if an asset falls in value over the period, this will show up in the accounts, as it rightly should, as a geared holding loss.

Godley and Cripps had been concerned with monetary liabilities, but there was also strong criticism of the Sandilands attitude to monetary assets. This criticism came notably from the banks, who argued that the Sandilands proposals were quite unsuitable for application to financial institutions.

The government gave its general blessing to the Sandilands Report and asked the accounting profession to work out a detailed programme for the introduction of CCA, a task that was given to a Steering Group under the chairmanship of Mr. Douglas Morpeth. The vexed question of monetary items was left open, and the Steering Group were asked to give it further consideration.

Like the Sandilands Committee, the Morpeth Group worked with commendable speed, and in November 1976 an Exposure Draft for a Proposed Standard on Current Cost Accounting (ED18) was published under the authority of the Accounting Standards Committee (ASC). At the same time there were published *Background Papers* and a somewhat formidable *Guidance Manual.*

It is evident from the *Background Papers* that members of the Group were not in full agreement amongst themselves on the question of monetary items. In the event they resorted to a compromise. In this they took the lead from a qualification in the Sandilands Report itself. Although the Sandilands Committee had fixed on Sandilands profit as the most suitable measure of profit for most purposes and for the great majority of companies, they were prepared to

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[4] An unpublished paper making the identical proposal was written at the same time as the Godley-and-Cripps article and independently of it. I would not, however, claim any originality for the proposal, because I had been very much influenced by the earlier exchange between Godley and Wood and Professor Day.

[5] Mr Gibbs' distinctive contribution has been to point out that to the extent that working capital is financed by trade credit, the extra finance required will be generated virtually automatically in the course of business. For a description of the 'Gibbs' system, see the *Background Papers* to ED18. Numerous research publications of Phillips and Drew have also done a very useful service in quantifying the likely effects on reported profits of the various proposals.

allow some discretion to directors in making transfers to and from the revaluation reserve in particular circumstances. ED18 now gave formal recognition to this discretionary element. Sandilands profit was retained as the central concept of profit, but the holding gains, relabelled revaluation surpluses, were then to be brought back into an appropriation account, and directors were to be allowed to decide what sum should in the end be appropriated to the revaluation reserve. The sum could be greater or less than the revaluation surpluses, and the only requirement was that the directors should explain the reasons for their decision.

In addition, and no doubt as a concession to the CPP viewpoint, ED18 also recommended that there should be a supplementary note to the accounts showing the inflation-corrected gain in the net equity interest of a company over the accountng period.[6]

The last recommendation encountered predictable opposition from opponents of the use of a general index,[7] while the proposed reintroduction of an appropriation account met almost universal criticism. Even so, it was probably not these recommendations that brought about the downfall of the Morpeth enterprise, but rather the complexity of the draft and especially of the *Guidance Manual.* It was felt that the draft had attempted to cover a number of peripheral areas of accounting, areas which were important enough in themselves and which had long troubled accountants, but which would have been better tackled in separate standards. As a result, there was a successful revolt against ED18 amongst the membership of the English Institute of Chartered Accountants, which rejected it by a vote at a special meeting.

Although it was clear that the preparation of a mandatory standard based on ED18 was no longer feasible, the leaders of the profession were reluctant in spite of the rebuff to relinquish all the ground gained in the lengthy struggle for inflation accounting, and in November 1977 the ASC published an Interim Recommendation on inflation accounting, commonly referred to as the 'Hyde Guidelines'. Since at the time of writing they represent the current state of play, I shall give them a section on their own.

The Hyde Guidelines

The Hyde Guidelines, like ED18, bear all the hallmarks of a compromise. Though no-one's ideal system, they have received widespread support, largely one feels because they are thought to be better than nothing, and, depending on one's point of view, not so bad as some of the other proposals that have been put forward.

In other respects, the Hyde Guidelines present a marked contrast to ED18. They are extremely modest by comparison, and of course not mandatory. They recommend that three adjustments should be made to the conventional historic cost profit figures in a supplementary statement. The first two are the familiar current cost adjustments to depreciation and cost of sales as proposed by Sandilands. The third adjustment, the gearing adjustment, is the one that deals with monetary items. It takes two alternative forms, depending on whether a company's monetary assets exceed its monetary liabilities or *vice versa.*

When the monetary assets of a company exceed its monetary liabilities, an adjustment is recommended that would reflect the increase in the net monetary assets needed to maintain its scale of operation. An appropriate index is to be used for the purpose, which need not be the retail price index.

When monetary liabilities exceed monetary assets, the recommendation is more controversial. Like Godley and Cripps, the Hyde Guidelines recommend that a geared proportion of holding gains should be brought back into profit, but the difference between the proposals is substantial. Whereas Godley and Cripps wished to apply the gearing proportion to all holding gains, the Hyde Guidelines recommend instead that it should be applied only to those holding gains represented by the adjustments to depreciation and sales. This is a very considerable emaciation of the original proposal, and the logic behind it is not immediately apparent. Nor do the Hyde Guidelines present any arguments in its justification. For these we must turn to the LDSCA Submission on ED18, in which as far as I know the Hyde compromise was first recommended. It is clear from paragraph 91 of the background papers in that document that the working party concerned rested their case on the dictates of prudence, and in particular on the principle that no element of *unrealised* revaluation surpluses should be brought into the profit-and-loss account.

The latter is of course a longstanding accounting principle, reaffirmed in SSAP2. It is doubtful, however, whether it can be sustained in a period of inflation. In the first place, it is one of the characteristics of inflation that holding gains will be predominantly positive and that a very substantial part of them will be unrealised. To exclude the geared proportion of these from the profit-and-loss account on the grounds of prudence involves too great a departure from realism. In the second place, for an ongoing manufacturing company, the distinction between realised and unrealised holding gains is of little, if any, significance.

The worry in people's minds, no doubt engendered by the property debacle of 1972-4, is that geared unrealised holding gains may represent a profit of poor quality, which it would be unwise to distribute. While this may be true in some circumstances, it is an insufficient reason for their general exclusion from profits. Their suppression, as recommended in the Hyde Guidelines, will result in a systematic and substantial understatement of company profits attributable to shareholders.

What next?

It is still the intention of the ASC to formulate proposals on price level accounting for promulgation as a standard or standards. So the obvious question to ask is: what next? Part of the answer is simple. The Hyde recommendations were confined to the profit-and-loss account, and the next step must surely be to make corresponding current cost adjustments to the balance sheet. The calculation of the depreciation

[6] The Consultative Committee of Accountancy Bodies (CCAB) had pressed for this in their initial reactions to the Sandilands Report. For a description of the CCAB 'ideal' system, see *Background Papers* to ED18.

[7] See, for example, the *Submission on ED18* by the London and District Society of Chartered Accounts (LDSCA).

adjustment and of the gearing proportion will in any case require the systematic revaluation of a large part of a company's assets, so that the extra labour required in extending this to cover all assets should not prove excessive. While there is room for argument as to what is the ideal approach to the valuation of assets, there is no doubt that the adoption of the Sandilands proposals based on deprival value would make for an *improvement* in the balance sheet over the present system based on historic cost, as well as over the CPP proposal that the historic-cost figures should be revalued by applying the retail price index to them.

When it comes to the profit-and-loss account, it is difficult to see how the Hyde recommendations can be used as a point of departure. To make progress we must take a step backward - *reculer pour mieux sauter*. The first requirement for progress is to rid ourselves of the notion that there is a single measure of profit suitable for all purposes and for all users of accounts. In their Submission on ED18, the LDSCA were particularly critical of the discretionary element introduced into ED18, but they still hoped to retain the notion of a single measure of profit. Paragraph 61 of the background papers in the document begins: 'A clear wish exists that current cost accounts should identify one line as the "profit of the year" and that this amount should be quantified by clearly defined rules.'

It is a wish that should not be encouraged. There are all sorts of purposes for which a measure of profit or gain is required: for management accounting, for the calculation of the return on capital employed, for wage negotiations, for pricing policy, for dividend distribution policy, in the calculation of price-earnings ratios or preferably earnings yields,[8] for investment analysis, for determining the inflation-corrected gain in the shareholders' interest, and as a basis for company taxation. One has only to list these purposes - and I do not claim the list to be exhaustive - to realise that no single measure of profit will be suitable for them all; and that if one insists on a single measure it is more than likely to be a compromise unsuitable for any of them.

Real and money measures of profit

In an attempt to sort out the various measures of profit that are required, and that should be presented in the accounts, two main distinctions have to be kept in mind. The first is the distinction between real and money measures of profit or gain.

I have argued earlier that CPP and CCA are both methods of correcting for price changes, and hence of establishing real measures of profit. The difference between them is concerned with the type of price index to be used. In the choice of index, dogmatism is out of place. For some purposes a specific index will be appropriate and for others a general index.

But it is also a mistake to suppose that a correction for price changes is always required. For some purposes, e.g. in the calculation of rates of profit on capital and of earnings yields, it is not obvious that a correction for price changes needs to be made at all. Certainly, no correction should be made if the intention is to compare the rates of return or yield with the uncorrected money rate of interest.[9] Admittedly, there is no harm in calculating real rates of return on capital or real earnings yields, provided it is understood that these are strictly for comparison only with a real rate of interest.

An entity view and a proprietary view

The second, and even more important, distinction that has to made is that between an *entity* view of the company and a *proprietary* view. On an entity view, the company is regarded as an entity in itself. Both shareholders and creditors are thought of as being outside the company. Both provide finance for the company and require to be compensated, but no distinction has to be made between their separate interests. On a proprietary view, the company belongs to the shareholders.

It is perhaps the most serious criticism of the Sandilands Report that this distinction was completely muffed. By charging interest payments against operating profit, so as to arrive at Sandilands profit, the Committee were taking neither a consistent entity view nor a consistent proprietary view. On an entity view, interest payments, which are a transfer from shareholders to creditors, should not be brought into the account at all: to deduct them as well as the whole of the adjustments to depreciation and cost of sales amounts to double-counting. On a proprietary view, the fault is one of not-counting: interest payments have to be deducted from profits, but something should have been brought in on the credit side to account for the real gain on the monetary liabilities, which is in effect a gain by shareholders at the expense of creditors.

The Committee (para. 536) justified the deduction of interest payments from operating profit on the grounds that they are an actual cost in money terms, in other words an outward cash flow. This is true, but they are not the only element of cash flow associated with debt finance. In an inflationary period, nominal debt can be expected to rise, and in fact does rise. The net new borrowing that this implies represents a cash inflow, a continuing cash inflow so long as the inflation continues. In short, Sandilands profit is a miscreation. Far from being used as the central concept of profit, it should not find a place at all in the income statement.

I shall conclude this section by indicating in Table 7.1 what I think is the appropriate view of the company for the various purposes listed earlier. I have not made an allocation as far as the basis for taxation is concerned, since this would require a discussion of the whole rationale of company taxation, a subject that would require a paper on its own. Some of the allocations in the table be thought open to question. The important point however, is that the matter should be discussed and agreed, so that the

[8] Why should we follow slavishly the deplorable transatlantic practice of turning the earnings yield upside down and using the reciprocal? It is not only that we may want to compare the earnings yield with a rate of interest. When earnings yields are low, the price-earnings ratio is much too sensitive to small changes in the yield. In the extreme case, zero or even negative earnings yields are perfectly comprehensible. An infinite or negative price-earnings ratio is a nonsense.

[9] In the case of earnings yields, I have argued this point in more detail in a paper in the *Journal of Business Finance and Accounting*, Spring 1976. It is not of course conventional historic-cost earnings that should be used, but rather figures for total money gain. Historic-cost earnings are rightly suspect, not as is commonly supposed because they are too high but because they are too low!

Table 7.1

Entity view	Proprietary view
Management accounting (non-financial aspects) Rate of return on capital employed Wage negotiations Pricing policy	Management accounting (financial aspects) Dividend distribution policy Earnings yields Investment analysis Inflation-corrected gain in the shareholders' interest

appropriate measure of profit can be used for the particular purpose in hand.

The treatment of monetary items

The CPP proposal for the treatment of monetary items was to use the retail price index to calculate the real gain from net monetary liabilities. The desirability of presenting in the accounts both an entity view and a proprietary view points instead to the need for a separate and asymmetrical treatment of monetary assets and liabilities. I refer here only to liabilities represented by borrowing. Trade creditors are almost certainly better thought of as negative monetary assets and set off against monetary assets (which include trade debtors), so as to arrive at a figure for net monetary assets, which could of course be negative.

Then, if we take as our starting-point the pre-interest current cost operating profit, we would first of all bring into profit any net interest received from net monetary assets and then make a deduction, to be transferred to reserves, to allow for the maintenance of net monetary assets in real terms, using specific indices of price changes where this is appropriate. This would give us a figure for what we may call *entity profit*.

From entity profit we would first deduct interest payments and then bring into profit the geared proportion of all holding gains (including the implicit holding gains represented by the transfer to reserves in respect of net monetary assets suggested in the preceding paragraph), and so arrive at a figure for what we may call *proprietary profit*. This latter would be the most suitable figure for use as a *basis* for dividend distribution policy, which does not of course imply that it would always be prudent to distribute proprietary profit in full.

It has already been established that the figure for geared gains is equivalent to a CPP calculation of the real gain on assets financed by borrowing. It follows from this that if we wish, as I certainly do myself, to show in the income statement a measure of the inflation-corrected gain in the shareholders' interest, as shown for example in the last line of the CCAB 'ideal' system, all that we have to do is to add to proprietary profit the inflation-corrected element of ungeared holding gains, using the retail price index for the purpose. At this stage, however, I prefer to make a small detour, so as to be able to show in the statement a figure for *total proprietary gain*, for use in the calculation of earnings yields. We can obtain this figure simply by adding the ungeared proportion of holding gains to proprietary profit. We can then deduct the inflationary element of all holding gains so as to arrive as before at the inflation-corrected gain in the shareholders' interest.

A simplified income statement

I can best summarise the proposals of the preceding section by setting down in Table 7.2 a simplified version of the income statement, simplified because tax, minorities and extraordinary items are ignored.

Table 7.2

	Current cost operating profit	X
plus	Interest received from net monetary assets	X
minus	Adjustment for maintenance of real value of net monetary assets	(X)
equals	*Entity profit*	X
minus	Interest paid on monetary liabilities	(X)
plus	Geared holding gains	X
equals	*Proprietary profit*	X
plus	Ungeared holding gains	X
equals	*Total proprietary gain*	X
minus	Inflationary element of all holding gains	(X)
equals	*Inflation-corrected proprietary gain*	X

I would claim for this presentation one virtue of omission, and four virtues of commission. The misconceived Sandilands figure of profit is by-passed altogether. Instead, four significant measures of profit or gain are presented in Entity profit. Proprietary profit, Total proprietary gain and Inflation-corrected proprietary gain.[11]

The suggestion that more than one measure of profit in the main statement of the accounts will confuse the users of the accounts has been greatly exaggerated. A user of the accounts can simply pick on the line in the statement most appropriate for his purpose. In any case, even if he is confused, it is definitely preferable that he should remain so than that he should be misled

[10] A case in point concerns the pricing policies of nationalised industries. On an entity view, prices would not be expected to cover interest costs. If they are expected to cover them, and especially if in Sandilands fashion no account is taken of the substantial real gains on monetary liabilities, the inevitable consequence is that when nominal interest rates rise with accelerating inflation, nationalised industry prices have to rise disproportionately compared to other prices. Since many of the nationalised industries provide essential services, the effect is equivalent to that of the most undesirable kind of indirect taxation, an indirect tax on essentials.

[11] Mr. Martin Gibbs would wish also to include in the statement a line showing 'maintainable cash profit' without recourse to borrowing (as distinct from trade credit). The concept is rather too close to Sandilands profit for my own taste, but if it were thought desirable to include it, this could be done by interposing a line after the deduction of interest payments from entity profit but before bringing in the geared holding gains. I would have no serious objection to this procedure, provided it were understood that proprietary profit was a figure of much greater significance.

by a single profit figure that he has not properly understood.

The true and fair view

The syndrome of the middle seventies has been a kind of accountants' *anorexia nervosa,* a desire to present the profitability of companies in the slimmest possible light. It was carried to its extreme in the Sandilands Report. I believe it has had a debilitating effect on the health of the economy, by restraining the recovery of the market capitalisation of the equity interest in companies to reasonable levels after the stock market collapse of 1973-4. The result has been that, in spite of a very large fall in the real rate of interest to substantially negative levels, the average real cost of capital has perversely risen. If inflation accounting is to play its part in curing this malady instead of aggravating it, what is wanted is a much smaller dose of 'prudence' and a much larger dose of 'the true and fair view'.