Writing the future: A theoretical justification for a uniform and universal system of currency in accounting for inflation

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Abstract: This paper submits that the advantages gained by introducing a single currency at the domestic level, applies equally to the economy at the global level. The advantages gained are (1) a reduction of the inflation rate to one common rate (if required) amongst all states, (2) a possible reduced interest rate, (3) an expansion in investment, (4) an increase in development and trade due to the removal of uncertainty, (5) the reduction in transaction costs, and (6) the reduction in the cost of capital (Moshirian, 2004, p. 306). A single global currency has immediate implications in accounting for inflation as it presents an opportunity for the permanent removal of problems associated with accounting for inflation. This paper addresses the phenomenon of inflation and how accounting measurement and valuation associated with inflation is removed by the introduction of a single global currency.

Key words: theoretical justification; uniform and universal system; inflation accounting

> "It would be difficult to exaggerate the psychological and social impact of the anticipated replacement of the jumble of existing monetary systems–for many, the ultimate fortress of nationalist pride – by a single world currency operating largely through electronic impulses."
>
> (Bahá'í International Community, 1999, p. 12)

1. Introduction

Under historical cost accounting, it is assumed that the monetary unit is the appropriate unit of account. A less researched problem, but one that persists in the accounting literature, and in international accounting, is the accounting for inflation, globally. The problem in accounting is that money, used as the unit of account, changes as a result of its purchasing power which leads to price increases (inflation) and decreases (deflation). Even if the purchasing power of the dollar does not change, the dollars received at different times are not equivalent because money has a time value. That is, a unit of money held now is worth more than the unit of money expected in a year's time. While managers, academics and accountants are aware of this, the impact of the changes to accounting has been largely ignored, despite these changes being real.

This paper provides a theoretical algebraic representation of the problem and proposes that a permanent solution to the problem is the introduction of a single global currency. A single global currency could ensure that all countries have the same rate of inflation (if any) and all financial reports could be measured using the same monetary unit. This needs to be complemented and supplemented by a single global accounting standard. A theoretical algebraic solution to the problem of inflation is provided, mostly extracted from two sources. These two sources are Ma and Mathews (1979) and Henderson and Peirson (1994).

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Accountants have attempted to cope with the problem of inflation by providing additional supplementary statements to historical cost accounting. For example, in the United States, in 1969, the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants issued Statement No. 3 and recommended the publication of general price-level financial statements in addition to those prepared on a historical cost basis (AICPA, 1969). This was rarely carried out in practice (AICPA, 1971, p. 49). In 1979, the FASB issued Statement No. 33, Financial Reporting and Changing Prices which was subsequently superseded in 1986 with Statement No. 89, effectively withdrawing the standard, due to its lack of use. The United Kingdom's attempt to deal with inflation came in the form of an Exposure Draft ED8, Accounting for Changes in the Purchasing Power of Money. In 1975, the Sandilands Committee proposed that historical cost system be replaced by a current-value accounting system. By 1988, after several exposure drafts, the mandatory status of SSAP16, following widespread non-compliance by companies, was withdrawn.

Other attempts to find accounting methods to cope with inflation include the introduction of current purchasing power accounting, (CPP), current-value accounting (Sandilands Committee, 1975) current cost accounting (CCA) (Edwards and Bell, 1961) and continuously contemporary accounting (CoCoA) (Chambers, 1966). However, little has changed and less has been added by way of accounting methods and remedies to solve the issue of accounting for inflation, and its causes. Recently, Clarke (2000, p. 267) pointed out that Chamber's brilliance in relation to price variation had to do with the failure in conventional accounting to incorporate the full financial effects of the medium, which is that of money, thus bringing to the fore the issue of inflation.

In its simplest form then, the problem may not be to passively ask how we account for the changing value of money, but rather to actively, create a medium, so that the value remains the same, over time and space. If this medium does change, that change is by a constant, over time and over space.

The research and literature in accounting for inflation has been of three types. The first has been generally prescriptive and normative (For example see ASCPA, *Accounting for Price-Level Changes (A Symposium)*, 1974; *Gynther's The First Preliminary Exposure Draft: A Method of Accounting for Changes in the Purchasing Power of Money*, 1966, 1975; ICAA and ASA, 1975; Edwards and Bell, 1961; Wright, 1965; Chambers, 1966; Sterling, 1970).

The second stream has been generally descriptive of the nature of the problem of inflation (For example see Mason, 1956; Mathews and Grant, 1958; AICPA, 1963; Rosenfield, 1969, 1972; Ijiri, 1975; Mathews, 1975; Baxter, 1975; Sandilands Report, 1975; Chambers 1975; Davidson, et al., 1976).

The third being generally positivist in nature (Jones, 1949, 1955; Mathew, 1965; Moonitz, 1970; Chambers, 1970, 1971; Sterling, 1972; Cutler and Westwick, 1973; Rosenfield, 1969; Morris, 1975; Ma and Miller, 1976; Ma, 1976; Trowell, 1992).

The descriptive and the positive, sadly, lack the idealism that the issue of inflation warrants. The prescriptive have been attempted with little application and agreement among accountants, academics and regulators.

2. Historical cost accounting

Historical cost accounting is a valuation system that has provided a framework for explaining "invested costs" where costs of all resources committed to an entity are accounted for and locked into a double entry framework with a record of the sources. The historical cost record system accounts for invested funds–their sources, investment, and movements. The profit and loss statement becomes a statement summarizing revenues

and expired costs. The balance sheet becomes a static statement that indicates the sources and disposition of funds at any given point in time. Maintenance of an entity's original money capital is fundamental to this system of accounting, mostly to protect creditors and eventually owners. Both the protection of creditors and owners was not always achieved because of the defects of the historical cost system due to the valuation of assets at amounts that reflect price levels of past periods and the complexities of and rapid changes in business conditions. This was further compounded by distributions of by way of tax and dividends, often made inadvertently out of real capital, resulting in negative savings for the period and in an erosion of invested capital in terms of its command over real resources. Historical cost accounting has proved to be inadequate and misleading. For a firm to remain financially viable, at a time of inflation, one or more of the following requirements must be met:

(1) The firm must continuously increase its profit mark-up, selling prices and rate of return on its historical cost investment;

(2) The firm must continuously increase its indebtedness;

(3) The firm must continuously raise fresh capital;

(4) It must continuously reduce the volume of its operating assets, and hence reduce the scale of its operations and its future profitability.[1]

3. The nature of the problem

Traditionally, the accounting equation is:

$$\text{Assets}=\text{Liabilities} \tag{1}$$

The balance sheet may be rearranged as follows:

$$\text{Monetary Assets} + \text{Non Monetary Assets}=\text{Monetary Liabilities} + \text{Residual Equity} \tag{2}$$

An accounting system based on maintaining intact the current purchasing power of the shareholder's equity must necessarily involve an end-of-year adjustment. This is necessary because of the change of the purchasing power of the monetary unit. However, not all items on the balance sheet are affected. Three types of price changes may be identified and isolated. First, the change that occurs in the general level of prices which is the change in the purchasing power of money over all goods and services. Second, changes in specific prices that affect the prices of particular goods and services and third, changes in the relative prices in the price of particular goods and services relative to the prices of all goods and services as reflected by the general level of prices.

At any given time, the balance sheet can be restated as:

$$(\text{Monetary Assets}-\text{Monetary Liabilities}) + \text{Non Monetary Assets}=\text{Residual Equity} \tag{3}$$

When there is an increase in the general level of prices of w per cent, the balance sheet at the end of the period must be adjusted by multiplying all items at the end of the period by $(1+w)$. Thus, at the end of the period, the accounting equation is:

$$[(\text{Monetary Assets}\ (1+w)-\text{Monetary Liabilities}\ (1+w)] + \text{Non Monetary Assets}\ X(1+w)=\text{Residual Equity}\ X(1+w) \tag{4}$$

However, the monetary assets less the monetary liabilities are not required since the rate of change is constant, for any and every period. Monetary items are fixed in money terms and are not changed by inflation. A more realistic expression then, is as follows, at any given time:

$$(\text{Monetary Assets} - \text{Monetary Liabilities}) + \text{Non Monetary Assets}\ X(1+w)=$$

[1] (Notes: The Commonwealth Committee of Inquiry into Inflation and Taxation, the Mathews Committee, 1975).

$$\text{Residual Equity } X(1+w) - \text{Net Monetary balances } X(w) \quad (5)$$

The net monetary balance (w) represents a purchasing power loss arising from holding net monetary assets during a period when the general price level increased by w per cent. The purchasing power of equity has and will decline by this amount.

The above equation assumes that there have been no transactions. To include transactions in the above equation, during the period t_1–t_0, the financial position at t_1 would be as follows:

$$\text{Monetary balance}_1 + \text{Non monetary assets}_1 = R_1 \quad (6)$$

Where, non monetary assets$_1$, is measured in t_1 prices. Profit y for the period would be as follows:

$$y = R_1 - R_0(1 + w) \quad (7)$$

Profits during the period could be earned only after maintaining the purchasing power of the equity at time t_0. That is, if a firm had a capital of \$1R1 at t_1 and the general level of prices rose by the proportion p at the end of the year t_2, there would be a necessity to have \$2R1(1+p) at t_2 to maintain the original capital.

4. The impact of changes in prices on particular firms in different countries

An anticipated problem associated with changing prices on a firm in any country, is that the structure of prices and the general prices effect firms differently in different countries. Chambers (1983, p. 9) points out that when the structure of prices change, firms in different countries may be forced to rearrange their purchases, buying less expensive substitutes, or increase their product range, to maintain their incomes. Firms may also merge with others for economies of scale, and may be acquired by other firms or may be forced out of business. Firms may also adjust their selling prices to the current prices, enabling these firms to continue operating under the new structure of prices. Firms that do not adjust their selling price may not be in a position to maintain their previous scale of operations. Firms who anticipate an increase in prices may build up stocks of inventories to overcome the rise in prices, which will subsequently increase the demand for prices and increase further the demand for credit and new investment funds. This in turn may enable some firms to gain and some firms to suffer from the relative shifts in price of the goods they buy, use and sell.

When prices change and is accompanied by inflation, non-monetary assets are worth more, but in depreciated dollars. The monetary assets of firms will become amounts in depreciated dollars. This leaves the firm to pay particular attention to the composition of its assets and liabilities.

A further problem associated with inflation is that workers will have sought higher wages to offset actual inflation. Taxes on income, both for the individual and the firm, will, as a consequence change, exercising great influence on the prices of goods and services. The price of goods will thus increase in order to finance debtors and working capital, and this keeps inflation unchecked.

A central issue with inflation is that the effects of these changes do not fall equally on all firms in the country, nor do they fall proportionately and simultaneously on all countries, over time. Some are enriched by the rising prices while other are impoverished.

This paper intends to provide a theoretical algebraic solution to the problem of inflation, and the accounting for inflation, by introducing the idea of a single global currency.

To summarize the nature of the problem, the historical cost model does not cope with changing prices. The historical cost model does not take into consideration (1) the instability of the measuring standard (i.e. the measuring medium), (2) as a consequence of the first reason, the relevance of historical cost accounting reports

for decision making in periods of rapid changes is questionable, (3) criticism that relate to the diversity and permissiveness of accounting practices, (4) business policy decisions made on dated information.

A further issue is that income in the current year will not purchase the same quantity of goods and services as in a previous period. General recognition of this is acknowledged in accounting as the financial statements treat the dollars of different years as identical and the amounts representing different, say, depreciable assets are added together as though the resulting total had some meaning. Accountants recognize, for example, that the Australian dollar differs from the US dollar and translate amounts expressed in US dollars into Australian dollars before including them in Australian financial statements. A currency expressed in different years is no more identical than are Australian and US dollars. Amounts expressed in dollars of different years should not be compared, added or subtracted unless they have been restated in terms of a common dollar, that is, in terms of dollars of the same general purchasing power.

5. Using an index to convert $\$1_{t1}$ to $\$2_{t2}$

This section provides an explanation to the remedy proposed, which is that of using an index to convert historical cost financial statements to current values. The value of an index is that it allows the changes in the financial significance of the monetary unit to be taken into account. The adjustment made by use of the rule \$1 = \$2(1+p) enables all goods to be priced at the value of the dollar at the end of the accounting period and allows all amounts in a balance sheet dated at t_2, expressed in \$2. The rule \$1 = \$2(1+p) avoids the need to add together two non addable numbers of dollars, and it ensures that all amounts in a balance sheet dated at t_2 are expressed in \$2. The index is a common denominator.

The historical cost financial statement may be restated to reflect the general purchasing power of the dollar at any point in time, mostly at the latest balance date. Restating the financial statements to current purchasing power may provide information that may be easily understood by users. The process itself may be divided into three steps, where the purchasing power gain or loss on net monetary assets or liabilities is calculated, by the restatement of the income statement and subsequently by the balance sheet.

In the current purchasing power accounting system, at any given time, the balance sheet equation, Assets = Liabilities, can be rearranged as follows:

$$M_o + N_o = R_o \quad (8)$$

Where M_o = net monetary assets at time t_o; N_o = non-monetary assets at time t_o; R_o= residual equity at time t_o

When there is an increase in the general level of prices of p per cent, then the balance sheet at t_1 could be adjusted by multiplying all items at t_o by (1+p).

Thus:

$$M_o(1+p) + N_o(1+p) = R_o(1+p) \quad (9)$$

Where $M_o(1+p)$ is the net monetary assets at time t_o multiplied by (1+p) to re express in the end-of-period dollars;

$N_o(1+p)$ is the cost of the non-monetary assets re-expressed in end-of-period dollars;

$R_o(1+p)$ represents the amount of residual equity adjusted for changes in the general level of prices at t_1.

However, the adjustment to M_o is not required as monetary items are fixed in money terms and are not changed by inflation. A more accurate expression at t_1 would be as follows:

$$M_o + N_o(1+p) = R_o(1+p) - M_o p \quad (10)$$

As can be readily observed, $M_o p$ represents a purchasing power loss arising from holding net monetary assets (M_o) during a period when the general price level increased by p per cent. Despite there be no transactions in $t_1 - t_0$ period, the financial position at t_1 would be as follows:

$$M_1 + N_1 = R_1 \quad (11)$$

where N_1 is measured in t_1 prices. Profit y for period t_1 would be as follows:

$$y = R_1 - R_o(1+p) \quad (12)$$

However, note that profit y can only be earned after maintaining intact the purchasing power of the equity at time t_o.

The problem here is the choice of the index. A perfectly representative index for all goods and services, expressed in the form of an index is near impossible. The consumer-price index (CPI) although widely used, falls short of representing all consumption. If the CPI index is adopted, we calculate the change in relation to the company and not shareholders. The index changes balances in the balance sheet which are already a mixture of differently dated amounts of moneys. Secondly, a generalized index cannot represent every particular price of assets at the beginning of the year to obtain an equivalent price at the end of the year. Finally, the net effect is only an adjustment and does not change the total amount of shareholders' equity.

The empirical evidence confirms the predicament, that some companies would report smaller profits while others would show larger profits (Davidson and Weil, 1975a and 1975b), that the impact of inflation varies greatly among individual firms and industry groups, (Parker, 1977) and the effects of price-level restatements on periodic earnings vary widely across companies but are not material in most instances (Staubus, 1976) and that reported earnings reduced and assets carrying amounts increased with the purchasing power gains not offsetting the impact of inflation on other items in the income statement (Parker and Gibbs, 1974).

6. The nature of continuously contemporary accounting

Under continuously contemporary accounting, proposed by Chambers (1983, p. 46), which is a model that uses a relative price change system using the market resale prices for the firm's asset, current resale prices are recorded continuously as price movements take place in the market. As it is not practical to record continuously both market prices and the general price level change, the recording of the general price level change is done at the end of the period. Opening equity is adjusted by reference to the change in the general price level during the period. If there has been an increase in the general price level, the amount of the capital maintenance is debited to income and credited to the opening equity balances of capital, reserves and retained earnings, proportionately.

Under the continuously contemporary accounting system at t_o the balance sheet equation, Assets = Liabilities, may be re written as:

$$M + N = R$$

where, M is net monetary assets; N is non-monetary assets; R is the residual equity

At time t_1, then

$$\$1M_1 + \$1N_1 = \$1R_1 \quad (13)$$

where, $\$1M_1$ represents the opening net monetary assets; $\$1N_1$ represents the ending net non-monetary assets; $\$1R_1$ represents the residue or shareholders' equity

Similarly, at t_2,

$$\$2M_2 + \$2N_2 = \$2R_2 \quad (14)$$

where, $\$2M_2$ represents the closing or ending net monetary assets, $\$2N_2$ represents the closing or ending non-monetary assets, $\$2R_2$ represents the residue or shareholders' equity profit y for the period would be,

$$\$2y_2 = \$2R_2 - \$1R_1 \quad (15)$$

where, $\$2y_2$ represents income at the end of a period t_2; $\$2R_2$ represents the residual amount at period t_2; $\$1R_1$ represents the residual amount at period t_1.

If the price index P1 at t_1 rose to P2 at t_2, the proportionate rise in the index is (P2-P1)/P1. This proportionate rise in the index is P. Since the proportionate rise in the general level of prices has increased by p, it will take $\$2(1+p)$ at t_2 to buy the same goods as \$1 would have bought at t_1.

Assuming there are no income-earning activities during the period t_o to t_1, but the general price index level increases by p (where $p = p_1 - p_o/p_o$) and the market selling price of the non-monetary assets increases by s (where $s = s_1 - s_o/s_o$). The increase in net worth for the period t_o to t_1 is derived when an adjustment is made for the general price level change such that the balance sheet at t_1 takes the following form:

$$M(1+p) + N(1+p) = R(1+p)$$

Changing the monetary assets by (1+p) is not required because both the monetary assets and the monetary liabilities are based on current values. Thus, the above equation may be written as:

$$M + N(1+p) = R(1+p) - Mp$$

An adjustment needs to be made to the balance sheet at t_1 to reflect the change in the selling price of the non-monetary assets, i.e. to restate N as $N(1+s)$. Since the non-monetary assets in the above equation are already stated at $N(1+p)$, the net adjustment factor is simply $(s - p)$ such that,

$$M+N[(1+p) +(s - p)] = R(1+p) - Mp +N(s - p)$$

which reduces to,

$$M+N(1+s) = R(1+p) - Mp + N(s - p)$$

To obtain the increase in net worth for the period, the equation M + N = R is subtracted from equation $M+N(1+s) = R(1+p) - Mp + N(s - p)$, and re arranged as follows:

$$Ns - Rp = N(s - p) - Mp$$

Income thus includes (in addition to current profit resulting from operations) the net effect of changes in the general price level and in the selling prices of the specific non-monetary assets held by the firm. The right-hand side of the above equation represents the purchasing power loss in a period of inflation from holding monetary assets,-Mp, and the real holding gain on non-monetary assets, $N(s - p)$. On the left-hand side, Ns represents adjustments for selling price variations that take place during the period, while Rp represents the general purchasing power adjustment of the opening equity. Rp is the consequence of a measurement scale transformation, to ensure that income in the continuously contemporary accounting model does not relate to the firm's operating capital but to its adaptive capacity.

Income on its own at t_2 can be represented as:

$$\$1 = \$2(1+p) \quad (16)$$

in general purchasing power terms.

Since $\$1 = \$2(1+p)$, profit y in period t_2, will be equal to,

$$\$2y_2 = \$2R_2 - \$2(1+p)R_1 \quad (17)$$

or

$$\$2y_2 = \$2(M2+N2) - \$2(1+p)(M1 + N1) \quad (18)$$

or

$$\$2(M2-M1) + \$2(N2 - N1) - \$2p(M1 + N1) \quad (19)$$

7. The nature of the current cost accounting system

In the Edwards and Bell system the end-of-period adjustment to historical cost financial statement is carried out by calculating the current operating profit, and results in maintaining operating capacity and business profit which holds financial capital, intact. Holding gains and losses, referred to as "realizable cost savings" are regarded as capital maintenance adjustments under the operating capacity concept where the "realizable cost savings" are included in the measurement of profit under the financial capital concept.

In this system, at any point in time, the accounting equation, Asset = Liabilities, can be re written as

$$M + N = R \quad (20)$$

Where, M represents net monetary assets; N represents the current cost of non-monetary assets; R is residual equity

When the current cost of the non-monetary asset increases by the percentage p, the balance sheet at the end of the period would be as follows:

$$M + N(1+p) = R + Nq \quad (21)$$

The term $N(1+p)$ represents the non-monetary asset at the beginning of the period at end-of-period current cost. Nq represents a gain to the entity because the non-monetary asset was held during a period when its current cost increased. The equity of the entity has risen from R to R+Nq during the period, representing the 'realizable cost saving' of Nq.

When there are transactions during the period, the operating profit y_c for any period is measured as follows:

$$y_c = S_c - C_c \quad (22)$$

where, y_c is the periodic profit; S_c is the periodic revenues; C_c is the expenses incurred in earning the revenues.

However, implementation of the current cost accounting system raises issues that are insurmountable. The first of these is the availability and the reliability of current cost data. Secondly, the use of specific price index numbers, in comparison with the effects of changes in the general levels of prices. This leads to questions about the usefulness and cost of providing the data. Other implementation problems are to do with the subjective and imprecise nature of the calculations. The imprecise nature of the calculations are further compounded by problems associated with the method of calculating gains and losses, problems associated with the choice of an index and problems associated with the magnitude of the gains and losses. Equally valid criticisms can be raised on the ground that it presupposes continued replacement of the assets held by the firm, which discourages redeployment of resources. Firms on current cost accounting are discouraged from adapting to the changing requirements of the economy. This is built on the assumption that firms subject to rapid increases in current values are thought to be less efficient than those subject to less rapid increases and that it is inequitable and inefficient for the consumer, through higher prices, the government and taxpayers, through lower taxes, to subsidize this inefficiency.

8. The nature of the solution

Under a single global currency, at any one point in time, the equation,

Monetary Assets + Non Monetary Assets = Monetary Liabilities + Residual Equity (23)

will hold. This is so because the measuring unit has not changed or if it has changed it changes by a constant, fixed rate, over time and over space. In the event that the purchasing power of the monetary unit erodes, the

erosion is by a constant amount over time and over space.

Thus the equation,

$$\text{Monetary Assets} + \text{Non Monetary Assets } (1 + w) = R(1 + w) \quad (24)$$

will hold, without a purchasing power loss.

9. Conclusion

This paper argues that a permanent solution to the problem in accounting relating to inflation is the introduction of a single global currency. A single global currency would ensure that all countries had the same rate of inflation (if any) and all financial reports would be measured using the same monetary unit. It is the permanent solution to the issue of accounting for inflation. A theoretical algebraic solution to the problem of inflation is also provided.

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