FIXED ASSET ACCOUNTING AND DECONTROL

CARMELITA G. SALGADO

The purpose of this article is to present the controversy in fixed asset accounting. This controversy has now become the burning issue in local accounting groups since the decontrol measures were passed in 1962.

The major feature of decontrol that has a bearing on fixed asset accounting is the exchange rate which is no longer being fixed administratively but is left to the operation of the law of supply and demand. In prior years, "fairly generous and inexpensive bases of exchange were made available to those who were setting up industries."[1] These industrial firms are now faced with the crucial problem of replacement of plant and equipment items on a considerably higher basis of exchange.

Income taxes, wage negotiations, and dividend decisions are vitally affected by these developments. Enterprise net income is a significant factor in these areas of decision and action. Thus, fixed asset valuation, which enters into the calculation of enterprise net income, deserves careful scrutiny. The accounting group, aware of these implications in the accounting reports, has undertaken the task of studying the problem in relation to the accounting procedures for fixed assets.

The issue is the establishment of the accounting method that would "present fairly"[2] the fixed assets and net income in the financial reports.

The accounting procedures for fixed assets have been maintained on the so-called "historical cost"[3] principle. The Tax Code provision recognizes depreciation on this basis as the proper deduction from taxable income.[4] This has strengthened the general application of the method.

The dilemma which confronts the accountants in the Philippines today is whether or not to continue to report fixed assets at their historical cost. The alternative is to adopt the "replacement cost"[5] method of valuation.

A comparison of the two methods is shown in the following illustrations:

X COMPANY

Balance Sheet as of December 31, 1963

ASSETS	Historical Cost Basis	Replacement Cost Basis
Non-depreciable Assets	₱ 300,000	₱ 300,000
Plant and Equipment	1,000,000	2,000,000
Less: Accumulated Depreciation	500,000	1,000,000
Net Book Value	₱ 500,000	₱ 1,000,000*
TOTAL ASSETS	₱ 800,000	₱ 1,300,000
EQUITIES		
Liabilities	₱ 400,000	₱ 400,000
Owners' Equity	400,000	400,000
Add: Appraisal Capital Resulting from Asset Revaluation	. . .	500,000
TOTAL EQUITIES	₱ 800,000	₱ 1,300.000

X COMPANY

Income Statement for the year ending December 31, 1963

Sales	₱ 500,000	₱ 500,000
Less: Cost of Goods Manufactured and Sold:		
Materials, Labor, and Overhead Costs excluding depreciation..	₱ 200,000	₱ 200,000
Depreciation		
1) based on historical cost ..	50,000	
2) based on replacement cost.		100,000
Total	₱ 250,000	₱ 300,000
Gross Profit	₱ 250,000	₱ 200,000
Deduct: General, Administrative, and Selling Expenses, etc.	150,000	150,000
Net Income Before Income Tax	₱ 100,000	₱ 50,000

The comparison shows that under the historical cost principle, the assets are expressed in their old low costs; while under the replacement method, they are presented at their current value or their "sound value."[6] Consequently, the equity appears understated in relation to the present value under the historical cost. A conjecture may be made here that there may be cases where assets in the balance sheet are shown as an aggregate total but are actually of heterogeneous costs. This is true of cases where the firm acquired assets prior and subsequent to the decontrol.

The illustrative income statement shows that historical cost depreciation results in a greater peso-figure profit, whereas the "reinvestment depreciation" or depreciation based on the replacement cost results in a lower peso-figure profit.

*sound value

THE HISTORICAL COST METHOD

The use of the historical cost procedure in accounting practice in the Philippines is one which was handed down by the American accountants who established the profession in this country. The continued use of the method is ensured by Philippine accounting education which is based on American textbooks.

Thus, the accounting practice in the Philippines has been based on the "generally accepted"[7] accounting principles promulgated by the American Institute of Certified Public Accountants and the American Accounting Association.

These two institutions have ruled that "historical cost"[11] should be the basis of financial reporting:

> "In periodic reports to stockholders, the primary financial statements, prepared by management and verified by the independent accountant, should, at the present stage of accounting development, continue to reflect historical dollar costs.
>
> "There is reason for believing that knowledge of the effects of the changing value of the dollar upon financial position and operating results may be useful information, if a practical and substantially uniform method of measurement and disclosure can be developed."[8]

In a subsequent bulletin dealing with depreciation and high costs, the Institute reiterated the move to adhere to depreciation on cost.[9]

The American Accounting Association Committee on Concepts and Standards Underlying Corporate Financial Statements commented that replacement cost, if taken as a measure of capital cost consumed, would destroy the objectivity of accounting data.

In view of the limitations of the historical cost method, it is suggested that supplementary statements be developed:

> "Management may properly include in periodic reports to stockholders comprehensive supplementary statements which present the effects of the fluctuations in the value of the dollar upon net income and upon the financial position.
>
> "Such supplementary statements should be internally consistent; the income statement and the balance sheet would both be adjusted by the same procedures, so that the figures in such complementary statements are coordinated and have the same relative significance.
>
> "Such supplementary statements should be reconciled in detail with the primary statements reflecting the unadjusted original dollar costs and should be regarded as an extension or elaboration of the primary statements than as a departure therefrom.

"Such supplementary statements should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the adjusted data."[10]

These decrees urging the use of historical cost method were the aftermath of the experience of revaluations in the 1920's and in the 1930's. In the 1920's, asset write-up's were made to provide a higher base by which to increase the depreciation charges at the time of inflation. However, in the 1930's, asset write-down's occurred to meet the conditions of deflation. These occurrences proved that revaluations were neither practicable nor desirable.[11]

Despite the bulletins that established the proper concept to be taken for depreciation charges and fixed asset valuations, this particular accounting problem on this controversy still goes on in accounting literature. The advent of decontrol has placed fixed asset accountancy in the Philippines in a similar predicament.

The proponents of the historical cost concept support the practice on various arguments and assumptions. Ananias Charles Littleton states that historical cost finds its strongest support "in the fact that it has been a natural cost, that is, a prior-figure representation of a known fact awaiting recording and association with other known facts."[12]

Furthermore, he argues that:

"Historical cost . . . means 'prior invested money price.' By using this sort of basic record, all parties at interest are better able to see, after the fact, the measure of prior decisions. If that backward look is denied them, as by the substitution of external current events not active within the enterprise, the essential function of accounting will have been negated and its outstanding characteristic will have been denied."[13]

The general view of those who advance the historical cost principle is that costs incurred constitute important measures of management's prior decisions and choices. The subsequent effectiveness of these choices and decisions must rest upon some dependable quantitative recorded data. Otherwise, prior choice could not be usefully compared with later results.

A distinction is made by this group that 1) the invested cost charged against revenue, and 2) the financial provisions made to replace depreciating assets are two separate actions, viz., enterprise operation and enterprise finance. Since they are fundamentally different, the former should be appropriately part of the periodic calculation of net profit, and the latter quite appropriately a matter of administrative decision.[14]

THE REPLACEMENT COST METHOD

However, the proposition that depreciation charges should be expressed on the basis of replacement cost has been asserted by certain quarters from time to time.

The main points that support this view are summarized as follows:

1. "Depreciation accounting should seek to make provisions for replacement, so that the plant as a physical producing entity may be maintained from revenues without calling on new capital in a period of advancing prices; depreciation charges should maintain capacity to produce, not merely dollar capital.
2. "In competitive business, it is current costs of labor, material, and plant which tend to influence selling prices and which are therefore especially significant to management.
3. "For purposes of insuring, financing, rate regulation, etc. where questions of equity between parties are involved, replacement costs are more important than recorded dollar costs."[15]

As to the validity of reports prepared on the basis of historical cost, the criticism is as follows:

> "It is not at all ridiculous to urge that in each successive year throughout service life, revenues should have been charged with the *current costs of the plant capacity consumed during the year*. The rents received each year are current dollars; maintenance, taxes, and other costs are being incurred largely or entirely in current dollars; and if net income is to be reported realistically, the cost of expiring plant must be stated in current dollars . . . it is fairly obvious that any business which fails to sell its product for a sufficient number of dollars to recoup the purchasing power invested and consumed in the particular period in the process of production is operating unsuccessfully — and any accounting report which shows a condition to the contrary is basically invalid. It is just as essential that revenues be sufficient to cover the actual costs of the coal burned in the plant if the business is to be regarded as having a net earning power."[16]

Moreover, the recommendation of the American Institute that replacement value be disclosed in supplementary statements accompanying the primary reports is considered unsatisfactory. In the Netherlands, replacement value has gained the status of being the "sound accounting practice"[17] in the determination of income and equity over the past forty years.

Replacement value is accepted in principle and in practice. As such, the principle has been integrated into the accounting system.

The Philips Company of the Netherlands justifies its application of the replacement value theory by restating what it believes are the objectives of the accounting system.

The accounting system must be designed in accordance with the principles of "accounting for management." The responsible managers must be informed periodically of the income and the capital employed, both in detail and in total. Replacement value theory, thus, is not merely a calculation technique but a basic principle of the accounting system of all sections of the concern at every stage. In this way, it ensures that all information for management is compiled in accordance with the principle of replacement. It automatically enters into all management considerations. Moreover, it is believed that the method of calculation of income and capital must be the same for internal and external purposes, varying only as to detail of information and frequency of issuance of reports. There should be no distinction in the information that management uses for effective operation and its account of its stewardship.

In South America, realistic accounting is based on the supplementary statement of Accounting Research Bulletin No. 33 which makes the following observation:

> "Should inflation proceed so far that original dollar costs lose their *practical significance*, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries."[19]

FIXED ASSET ACCOUNTING PRACTICES ABROAD

In the study made by James H. MacNeill, it was observed that the accounting for fixed assets on the replacement value was widespread in countries whose governments felt the necessity to solve what might lead to financial chaos, and whose desire was to stimulate investment and the rebuilding of industries.

The governments that have permitted asset write-up in varying degrees were: Italy, Japan, Argentina, Belgium, China, France. Germany and Peru. In England, and even in traditionally conservative British Commonwealth nations of Australia and Canada, this practice as an accounting procedure is fairly widespread. In Australia, for instance, revaluations were carried out only once without subsequent revisions.

The Belgian government pioneered the move to give tax relief by prescribing a single asset write-up providing incentive for compliance along tax regulations. France, Germany and Italy allowed charges against income of replacement reserves as a tax deduction. In Japan, after years of struggling with historical cost, the government enacted a series of revaluation laws that were finally made compulsory in 1954 for depreciable assets.

The study of revaluation in these twelve countries proves that however faulty certain applications of the replacement value theory or whatever the stimulus for their application, traditional accounting procedures are abandoned when they are deemed inadequate.[20]

In an attempt to clarify the issue, and perhaps to resolve the controversy in the course of time, the American Institute of Certified Public Accountants recently launched a study of the financial effects of price-level changes.[21] The Accounting Principles Board was in agreement that the accounting assumption that fluctuations in the dollar may be ignored is unrealistic. The "Highlights" section of the report, however, while expressing the desirability of disclosure of the effects of changes in the purchasing power of the dollar, assumed that replacement costs are *not* to be introduced into the financial statements.

THE PHILIPPINE PROBLEM

It must be pointed out that, whereas the controversy between historical cost and replacement value in the preceding discussion is basically parallel to the controversy now raging among accounting groups in the Philippines, there are certain aspects where the Philippine problem differs. The replacement value problem abroad and the Philippine problem of replacement both involve an adjustment to write up the fixed assets. But while the former is a persistent problem arising from inflation, the latter is a unique case of higher replacement value on a higher exchange rate as an offshoot of a change of governmental policy. Moreover, the adjustment proposed in the application of replacement value abroad is one involving the use of index numbers. The type of adjustment that may be contemplated in the Philippine case is one which requires expert appraisal of the fixed assets and a single write-up of only those assets acquired prior to the decontrol.[22] The purpose of such a write-up is to bring the old low asset costs in line with the current value of similar assets.

In the meantime that such an adjustment is not taken up in the financial statements, certain assets will remain understated in terms of their replacement or current values on the prevailing exchange rates. Consequently, the net income calculated on such basis will remain to be open to criticism as being unrealistic to the extent that current revenue is not charged with current costs. This becomes even more significant when we presume that "costs will go up owing to the new exchange rate. . . . prices will probably not go up in the same proportion owing to competition from imports"[23] is a valid assumption. This suggests that income will be even more insufficient to provide funds for future replacements, at least for quite some time.

CONCLUSION

The foregoing observations lead to the conclusions that the financial statements as such have lost some of their practical significance. To venture to say that few investors and management groups can see through the limitations of the present data of income is not unfounded. Dividend distributions from income may therefore entail the risk of distributing funds which do not really represent real profit but funds required for replacement. Even wage negotiation decisions may be based on unrealistic income as would certain sales prices based on costs.

Similarly, the net taxable income calculated on historical cost may not necessarily be a valid tax base. Taxation in such a case may have adverse effects on the continuity of the enterprise to the extent that funds for replacement are taxed.

Although tax principles are based on sound accounting as indicated by the tax regulations,[24] and while financial statements are prepared on the basis of historical cost, the case that revaluation-cost depreciation be recognized by the tax authorities will have poor support.

The Philippines being in the process of industrialization, the recommendation of asset re-adjustment "on the grounds that it tends to promote stability through its effects upon business spending decisions to the extent that business spending are based on state profits"[25] seems justified.

Accounting theory, however, must determine the proper guide in the portrayal of what is *right* in an accounting matter. To "present fairly" the equity and profit of a business enterprise under the present circumstances, it is the replacement value theory which must be the basis of fixed asset accounting. This seems to be the only logical response to the problem that has arisen.

NOTES

1. Benito F. Legarda, "Foreign Exchange Decontrol and the Redirection of Income Flows," *The Philippine Economic Journal,* Vol. 1, No. 1.

2. "For the independent auditor to express an unqualified opinion, he must be satisfied with the accuracy of the representation contained in the financial statements. The degree of accuracy required is expressed in the auditor's report by the term "present fairly". The adverb "fairly" obviously indicates that the auditor is taking responsibility for something less than absolute accuracy. This degree of accuracy might well be expressed as 'freedom from material misstatement." Robert L. Grinaker, "The Accountant's Responsibility in Expressing an Opinion," *The Journal of Accountancy* (November 1960).

3. "Cost of present owner at the time of acquisition." Kohler, Eric, *A Dictionary for Accountants.* New York: Prentice Hall, 1954.
4. "A reasonable allowance or deterioration of property arising out of its use or employment in the business or trade or out of its not being used: *Provided*, that when the allowance authorized under the subsection shall equal the *capital invested* by the tax payer . . . " National Internal Revenue Code, Sec. 30 (f).
5. "The cost at current prices, in a particular locality or market area, of replacing an item of property or of a group of assets." Kohler, *op. cit.*
6. "Present reproduction/replacement cost less depreciation to date based upon such value." Krom Karrenbrock. Wilbert E. and Simmons Harry. *Intermediate Accounting*. South Western Publishing Co., Ohio.
7. "Given authoritative recognition; said of 'accounting principles, or audit standards' q. v., and the pronouncements concerning them, particularly, in recent years. Those of the American Institute of Certified Public Accountants and the American Accounting Association." Kohler, *op. cit.*
8. Accounting Research Bulletin No. 5, *CPA Handbook*, Chapter 17.
9. Accounting Research Bulletin No. 33, AICPA. New York. "Depreciation and High Costs." 1947, p. 268.
10. Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements, "Price Level Changes and Financial Statements," (Columbus: American Accounting Association), 1957.
11. A. C. Littleton and V. K. Zimmerman Accounting Theory: *Continuity and Change*. New Jersey: Prentice-Hall, Inc., 1962.
12. A. C. Littleton, *Essays on Accountancy*. Urbana: University of Illinois Press, 1961.
13. *Ibid.*
14. Littleton and Zimmerman, *op. cit.*, p. 165.
15. W. A. Paton, *Accountant's Handbook*, 3rd ed. New York: Ronald Press Co., 1953.
16. W. A. Paton, "Depreciation Concept and Measurement," *The Journal of Accountancy* (October 1959).
17. While in the U.S. an accounting principle is referred to as "generally accepted", in the Netherlands the yardstick of accounting principle is the concept of sound accounting practice as the basis from which both economic and accounting principles have evolved. Thus, the replacement value has been accepted over a period of forty years. (See also *The Journal of Accountancy*, July 1960).
18. *Ibid.*
19. Max Epps, "Realistic Accounting Under South American Inflation," *The Journal of Accountancy* (Jan. 1961).
20. James MacNeill, "Accounting for Inflation Abroad," *The Journal of Accountancy* (August 1961).
21. Cecilia Tierney, "Price Level Adjustment-Problem in Perspective," *The Journal of Accountancy* (November 1963).
22. This may be patterned after the determination of fair market value of property acquired before March 1, 1913 at the time the National Internal Revenue Code was adopted. (See also Sec. 30 F).
23. Legarda, *op. cit.*
24. "The fundamental rule that the computation shall be made in such a manner as would clearly reflect the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for . . ." (Sec. 37, Rev. Regs. No. 2) "Approved standards of accounting will ordinarily be regarded as clearly reflecting income ..." (Sec. 38, Regs. No. 2).
25. J. F. Barron, "Tax Equity and Retroactive Tax Adjustments," *The Journal of Accountancy* (Aug. 1959).