

HOW THE ACCOUNTING AND TAX PROBLEMS OF A RISING PRICE LEVEL HAVE BEEN DEALT WITH IN SWEDEN

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Among the European countries, Sweden is one of those, in which the general inflation which has taken place all over the world during the last decade, has been relatively least serious. This is mainly due to a strict price control, which was instituted in 1939 and which is still in effect, and other measures taken by the government.

Whereas prices developed comparatively alike in Holland and Sweden up to 1944, the price increases after that time have been smaller in Sweden than in Holland, as can be seen from the following table. (1937 prices = 100 in all columns.)

	Wholesale price index		Cost of living index		Construction cost index
	Holland	Sweden	Holland	Sweden	Stockholm
1939	97	101	102	105	104
1940	120	128	117	118	117
1941	138	151	134	134	124
1942	145	166	143	144	137
1943	148	172	149	146	141
1944	151	172	153	145	140
1945	167	170	176	145	140
1946	232	163	192	145	146
1947	250	175	199	150	156
1948	259	188	205	157	164

This continuous but relatively moderate decline in the value of money in Sweden has not, at least yet, made necessary the special legal provisions due to inflation, such as a revaluation of all assets, which have been instituted or contemplated in several other European countries. On the other hand, it has been big enough to have had a substantial inflationary effect on reported business earnings and taxes, if Swedish business men, accountants, and legislators had not been relatively well aware of the dangers and taken measures to neutralize the results as far as possible. Perhaps the most interesting side of this development, and the one that specially justifies a description for foreign readers, is the part that the tax laws have played in making possible to a large extent elimination of inflationary profits from taxable income.

The main influences on a country's accounting practice generally come from the following fields:

1. Accounting theory and education.
2. Professional public accountants.
3. Industrial and branch associations.
4. Legislation:
 - a. Civil law.
 - b. Tax law.

In *accounting theory* the problems of a changing price level have of course been long observed and discussed. Particularly the experiences during the first world war, when inflation, both in Sweden and in most other countries, was more severe than now and traditional accounting principles proved inadequate to meet the demands of the situation, led to the idea that inflationary „paper profits” should be eliminated from the profit and loss account. The influence from German authors, who have been specially keen in stressing this point of view, on Swedish accounting theory has been considerable. The leading proponent for this idea in Sweden during the 1920's and 1930's has been Professor O. Sillén, a most influential scientist and teacher in accounting. Through his and his colleagues' teaching and writing and through the *professional public accountants* the new ideas on inflationary profits in accounting were made known to business, where they became quite generally accepted, especially when the dangers became imminent in 1939 and the following years.

The *industrial and branch associations* — very important factors in Swedish business life — have not done much to forward these points of view in financial accounting, but it should be noted that in 1936 the Federation of Swedish Industries published a book, „Uniform Principles of Cost Accounting”, in which the replacement cost principle was recommended for all cost accounting purposes. The book stated that material, due to be replaced, should be valued in cost accounting at replacement cost. Depreciation of fixed assets ought to be calculated in cost accounting on replacement cost, and interest on replacement cost less accumulated depreciation. The „Uniform Principles” were later recommended by the Swedish Standards Association and have had an important influence on cost accounting practice. The replacement cost principle was also acknowledged by the Price Control Board, when this government authority started its work in 1939.

With regard to *civil law*, the most important acts concerning accounting matters are the Companies Act (a new Companies Act of 1944 has replaced the old act of 1910 from Jan. 1, 1948) and the Accounting Act (1929). These acts contain certain rules on the valuation of balance-sheet items, the Companies Act for joint-stock companies and the Accounting Act for most other forms of business enterprises. In short, the most important of these rules require that stock-in-trade may not be carried at a higher value than „cost or market, whichever is the lower”, and fixed assets not higher than cost less accumulated depreciation. These are maximum values, however, and undervaluation in the form of secret reserves is freely permitted by these acts. The legislators have here only wanted to prevent the showing of fictitious profits by means of overvaluation of assets or undervaluation of liabilities.

By special provision in the Companies Act of 1944 a company is now permitted to raise the book value of fixed assets, when their actual value is considerably and permanently above their former book value, but the amount of this write-up may not be paid out in a cash dividend, because it must be used either for a corresponding write-down of other fixed assets or for an increase in the share capital („share dividend”). This possibility has seldom been used in practice and the transaction has no effect on taxation.

The special rules and provisions in *tax law* will be dealt with at length

on the following pages. Here I just want to point out a few general facts. The taxes of main interest to Swedish business are the municipal income tax and the national income tax. The fundamental rules for the determination of taxable income are to be found in the Municipal Tax Law (MTL). Whereas an individual pays a proportional municipal income tax (on his income less certain general deduction) but a national income tax according to a highly progressive scale, both taxes are proportional for joint-stock companies¹⁾. The total of municipal and national income taxes, which I will call henceforth „the ordinary taxes”, for a company amounted to around 28 % of the company's taxable net profit in 1938, to 37-39 % in 1940—1947, and to 46 % since 1948.²⁾

A very important principle in Swedish tax laws is „the inviolability of the taxable year,” which means that each year is taxed entirely as a separate unit. Thus a loss suffered during one year may not be deducted from profits during the following years, nor does it entitle the taxpayer to a repayment of taxes. In order to avoid unfair effects for the taxpayers arising from the application of this principle, it has been found necessary to make the rules regarding determination of taxable income for ordinary taxes very liberal. This has been carried furthest in the case of companies. Because these have only proportional taxes, it has been the idea of the tax legislators that — with some limitations — it could be left to the judgment of the companies to determine the amount of profit to be taxed in each year. If a company wants to create or increase a secret reserve one year, the amount must always appear on the tax return some time, at least at the liquidation of the company, unless the reserve is used to cover losses during bad years, which should also be permitted. (The possibility of lower tax rates in the future has apparently seemed very small). This liberal rule has two other advantages from the legislators' point of view. Firstly, it tends to reduce the fluctuations in taxes collected during different years by the state and the municipalities. Secondly, the legislators who were well aware of the developments in accounting theory, wanted to enable and even encourage business to apply the accounting methods best suited to the situation, e.g. to deal with the problems of a changing price level.

During the war years an extra national tax on excess war profits was added to the ordinary taxes. With some generalization we might say that every increase in profit from the average profit of 1937 and 1938 was considered excess war profit, unless it could be proved that the increase was due to special conditions, which would have had the same effect even if the war had not been going on. This excess-profits tax was in effect Sept. 1, 1939 — Dec. 31, 1945. Its importance to the national treasury was small, although tax rates were very high, but the reason for mentioning it here is the fact that some of the rules for profit determination in the Excess-Profits Tax Law are quite interesting for our subject, as will be shown later. Because the tax was of a temporary nature these rules had to be much more restrictive than those applicable to the ordinary taxes, but they were specially worked out so as to exempt from taxation the fictitious „inflationary profits”.

¹⁾ The joint-stock company (aktiebolag) is by far the most important form in which business is carried on in Sweden. There are approximately 30.000 companies in the country.

²⁾ In addition, shareholders have to pay income taxes on the full amount of dividends received.

If we accept the point of view that such accounting principles should be used as eliminate from reported profit and taxable income the effects of the changing price level, two groups of balance-sheet items deserve special attention: a. stock-in-trade; b. fixed assets. When a revaluation of assets is not contemplated, either because it cannot legally be done or because a future fall in prices may be expected, the question will be: what methods of valuation should be used for these assets in the balance sheet (or for corresponding reserves on the liability side, such as replacement and depreciation reserves) in a time of rising prices in order to reach the goal set up for the profit and loss account?

This is not the place to discuss these problems theoretically. That has been done by so many authors all over the world during the past few years. Instead we will give a short description of the principal rules of the Swedish tax laws and the development in Swedish accounting practice with regard to the assets just mentioned.

Stock-in-trade.

For the ordinary taxes the general rule about stock-in-trade in the MTL runs: „In the calculation of taxable income, the valuation of stock-in-trade that the taxpayer has used in his accounts shall be deviated from only where there are very reasons for so doing”.

If the taxpayer can show that he has been consequently using a certain acceptable method of stock valuation, the tax courts will thus usually approve his calculations. But the legal rule may also be misused by companies and other taxpayers, whose only „principle of valuation” is to minimize or postpone taxes as far as possible, and in such cases tax courts have been more restrictive. One important tax court found it necessary in 1948 to set a limit for these cases: stock-in-trade in industrial undertakings might be written down only to the lower of 30 % of replacement cost or 60 % of pre-war cost. It seems probable that this court ruling, liberal enough in most cases, will be upheld by the Supreme Tax Court.

A special problem arises when, due to scarcity of goods, the supply of goods on hand is far below normal. A company that uses the base-stock method or similar methods of stock valuation, will then have to deduct from the stock value a reserve for replacement, and if the stock is small enough the result might be a negative stock value. This would not be accepted according to the ordinary tax rules, but by a special law, companies have been permitted to set up on the liability side of the balance sheet an „investment reserve for stock-in-trade”. The amount set aside in this way is deductible, but not more than 20 % (in special cases up to 35 %) of the company’s profit before income taxes may be transferred each year to this reserve or the other „investment reserves” that will be mentioned later on. The „investment reserve for stock-in-trade” should be used in a following year, when stocks are more normal in size, to write down the value of stock. A similar provision for other taxpayers than companies is temporarily in force (for the taxable years 1947-1949).

In the Excess-Profits Tax Law (EPTL) it was of course necessary to give more exact rules for stock valuation. During most years of the law’s existence the taxpayer was permitted to value his stock at pre-war prices and to deduct from the amount arrived to in this way the amount of the secret reserve that he might have had before the war. In this way inflationary profits from rising prices of goods were exempted from taxation. The rule was somewhat modified in 1945, the last year of the excess-profits

tax, when valuation at pre-war prices less pre-war secret reserve was only allowed for the quantity of stock that corresponded to the stock on hand at Dec. 31, 1938 (pre-war stock). Stock in excess of pre-war stock might not be valued at less than the lower of actual cost or 140 % of pre-war prices, as it was considered improbable that the general price level after the war would fall below 140 % of pre-war prices. If the stock at Dec. 31, 1945, was less than pre-war stock, a deduction of 40 % of pre-war cost for the missing quantity was granted.

The effects of the tax laws on stock valuation in business practice have been considerable. Notably the EPTL called the attention of business men and accountants to the problems of inflationary profits, and during the war years it was customary in all profitable enterprises to use the method of stock valuation that was permitted by the EPTL. Similar valuation methods — such as the base-stock method and others — have been commonly used in the following years. There are many less profitable enterprises, however, who have not „afforded” to be quite so cautious in their stock valuation, because they would then have been forced to show a loss and lose taxes, and there are others who have after the war written down their stocks far below what the EPTL permitted. The development in different companies has thus been quite varying, and it must unfortunately be stated that not all companies, perhaps not even the majority of them, have consequently adhered to a determined method of valuation.

It may be said in general that now most leading big companies in Sweden in their balance sheets report a value of stock-in-trade that is very far — often 50 % or more — below present replacement cost, but it is usually not possible for anyone outside a company to know exactly the position of the company as regards stock-in-trade, as the law does not require the companies to make public their methods of valuation. The Companies Act prescribes that any material changes in the principles of valuation shall be mentioned in the annual report of the company, but this may be done in a fairly general way without giving any detailed figures on the effect of the change. If a secret reserve is dissolved, however, the fact must be disclosed, and it is one of the major responsibilities of the company's auditors to ascertain that this is done.

Fixed assets.

As we are here interested mainly in depreciation policies, I will discuss only the two most important groups of depreciable fixed assets:

a. buildings; b. machinery and equipment (including ships and other transport equipment, furniture etc.).

From the point of view that has been advanced in this paper, depreciation should generally be computed on replacement cost, not historical cost.³⁾ This is necessary in order to prevent overstatement of real profits and to safeguard the real capacity of the business. The Swedish tax laws have not permitted depreciation on replacement cost in principle, but in certain cases the rules on depreciation are so liberal that it is possible for the taxpayer to apply this method of depreciation, at least to some extent.

For *buildings* used in business, depreciation as a deduction for income-

³⁾ In accounting theory there is some difference of opinion whether one should use the replacement cost of each particular asset or the historical cost, converted to present value by means of a general price index. For our purposes here it is not necessary to differentiate between these two possibilities.

tax purposes is generally only allowed as a certain percentage — different for different kinds of buildings — of the actual (historical) cost to the present owner.

The same rule stands for *machinery and equipment*, but here we have some very important exceptions in the MTL (exceptions nos. 2 and 3 did not appear in the EPTL):

1. If the expected life-time of the asset is not more than three years, the whole cost may be written off at once in the year of acquisition.
2. If the taxpayer one year cannot utilize in full the deduction for depreciation — e.g. because his accounts show a loss for the year — he may use the deduction during some following, profitable year.
3. Most important is however that companies — and some other forms of business, which have also only taxes proportional to the taxable income — have been granted since 1938 the right to so-called „free depreciation” of machinery and equipment. „Free depreciation” means that, within certain wide limits, whatever depreciation the company has made in its accounts will be accepted by the tax authorities. In this way it has even been made possible for companies to use depreciation on the replacement cost of these kinds of assets, provided that current replacements are made, so that the book value of machinery and equipment less accumulated depreciation is kept a positive amount. It would be an overstatement to say that many companies have used the privilege of „free depreciation” in exactly this way, but in any case most companies’ depreciation of machinery and equipment has been during the war years and afterwards greatly in excess of normal depreciation on actual costs. As has been pointed out before, depreciation on replacement cost has for many years been fairly generally accepted in cost accounting, and it is quite natural that depreciation in cost accounting has influenced the depreciation in financial accounting.

„Free depreciation” is not allowed for buildings. Most companies limit their depreciation of buildings in the accounts to the same amount as is permitted with regard to taxes, but there is of course often the possibility to use „free depreciation” — as has been done by some companies — to compensate the too small depreciation of buildings (in relation to their replacement cost) by making correspondingly bigger depreciation of machinery and equipment.

„Free depreciation” has frequently been used in a somewhat less legitimate way: to equalize profits to some extent, by means of substantial write-downs in good years and limited depreciation in lean years. This practice might perhaps not be considered to be too dangerous, since depreciation must be shown as a separate amount in the profit and loss account, and the company must at least comply with the rule in the Companies Act that a fixed asset may not be carried at a higher value than actual cost less accumulated normal depreciation. Some companies have made full use of the possibility that „free depreciation” gives them to get a tax credit, by writing down machinery and equipment to the nominal amount of 1 krona.

As a consequence of the „free depreciation”, the MTL states that if a company sells some machinery or equipment, the total selling price is taxable income.

„Free depreciation” was not allowed by the EPTL, which instead required normal depreciation on actual costs. To give the taxpayer some relief in view of the rising prices, there was however in the EPTL a rule that entitled the taxpayer — in most cases — to an immediate write-off of

„excess prices” paid for new buildings, machinery and equipment. The „excess price” was then estimated to be the difference between (a) the purchase price or construction cost of the asset and (b) 125 % (in 1945: 140 %) of estimated pre-war cost. The „excess price” was written off in the year of acquisition or construction and the remainder was then subject to normal depreciation. A similar rule on „excess prices” existed and still exists in the MTL, but it has lost its importance after the end of the war, when the tax courts have interpreted it very restrictively.

As I pointed out before, „free depreciation” will not make it possible to use depreciation on replacement cost, when replacements are not made currently. There is however in this case, too, a way out of the difficulties, similar to the one we can use when stocks are low. The same special law that deals with „investment reserves for stock-in-trade” also permits a company to set up, tax-free, an „investment reserve for buildings” and/or an „investment reserve for machinery and equipment”. The limit for amounts that can be put aside in this way has already been mentioned in connection with „investment reserve for stock-in-trade”. Similar to that reserve, the „investment reserves” for fixed assets are to be used in some following year for a write-down of new buildings and equipment, acquired during that year. — The „investment reserve” legislation is however at the same time a part of the government’s program to level out business cycles. It is intended to encourage business to put aside profits in years of prosperity in order to ensure larger investments in real capital during a depression. Therefore, the different „investment reserves” set up are not free to be used for their intended purpose whenever the company wants to take them; special permission to use them must first be obtained from the Labour Market Board.

Conclusion.

This short survey will have shown that due to the liberality of Swedish tax laws — especially with regard to stock valuation and depreciation of machinery and equipment — it has been possible to a very large extent to avoid the unfortunate effects of taxes on fictitious inflationary profits. On the other hand, the actual development in Swedish business practice and the often unduly big secret reserves that have been accumulated in many companies, may suggest that the tax rules have been too liberal, at least for companies. There is in fact now a tendency on the part of tax authorities and courts to limit somewhat the freedom of business in this respect. At the same time, in the field of civil law, a Royal committee has recently proposed some amendments to the Companies Act, by which companies would be required to make public certain information about their secret reserves.

It may finally be said that the tax rules and accounting practice in Sweden obviously have had some effect in making Swedish business life unusually stable. In the many hundred million kronor of secret reserves in the companies, these have accumulated a power not only to withstand the effect of a future fall in prices but also to a large extent to continue paying taxes and dividends in bad years that may come. This stability is reflected in the low return that is asked for money invested in the big companies. While with present (October 1949) quotations Swedish government long-term bonds give a yield of 3 %, a company can sell $3\frac{1}{4}$ % debentures, secured by mortgage, at par. The average yield (in dividends) of shares quoted on the Stockholm Stock Exchange is now $4\frac{1}{2}$ %. There have been only small fluctuations in these figures since 1945.