

HARMONISATION OF ACCOUNTING PRINCIPLES AND THE CONCEPT OF PROFIT

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I. Introduction

No one will disagree about the desirability of achieving a greater measure of uniformity in the way in which the financial statements of companies are prepared in our various countries. It is, therefore, a good thing that the subject of international harmonisation of accounting principles will be discussed at the 9th International Congress of Accountants. At the present time, as international economic relations have grown to an extent and a significance as never before, the periodical financial reports of companies form an important function in regulating the flow and direction of international business-capital. In order to fulfil this function to the maximum extent, the comparability of these reports is an important requirement. If we have interpreted their views correctly, those who proposed the subjects for discussion at the Congress are of the opinion that mutual comparability of the reports published by companies in our various countries is an important, if not the most important object of international harmonisation of accounting principles.

The reader who expects that in this paper specific concrete proposals will be made for the realisation of international harmonisation of accounting principles will, I am afraid, be disappointed. I am of the opinion that we have not yet reached that stage.

We shall first have to consider the basis from which we should start and the procedures which will have to be followed in order to give practical meaning to the international harmonisation of accounting principles.

We must realise at the outset, however unpleasant this may be, that at various national levels the problem of harmonisation of accounting principles has not been fully solved. This national aspect of the problem of harmonisation is even more urgent than the international aspect; within each country the number of people who are concerned with the comparability of reports because they have to base their decisions thereon is certainly greater than the number of those who need comparability on an international level. For instance, national governments have to base their economic and monetary policies on the strength of the information in question.

Furthermore, another aspect of comparability as the aim of harmonisation in accounting principles has to be considered. Comparability can never be one of the prime requirements of reports. The prime requirements, as I see them, are: fairness (or if you like, reliability) and disclosure. And so far as companies are concerned, the desire to achieve comparability by harmonisation of accounting principles should also be balanced by the justified desire that rules regarding the information and the manner in which it is to be supplied by them must not be unnecessarily rigid.

II. The present situation as regards harmonisation of accounting principles

I am of the opinion that the present situation cannot be considered satisfactory.

On a national level the problems in question are far from solved. By way of example let us consider at random the situation in certain countries. If I have

correctly understood the publications that reach us, discussion in the United States concerning „generally accepted accounting principles” has been more active in the last few years than ever before, but the feeling exists (not only among our professional colleagues but also among other interested parties such as bankers, investment experts and groups of employers) that there is insufficient uniformity on many points. I have the impression that there is a growing conviction that without formulating certain common fundamental concepts one cannot really arrive at generally accepted accounting principles and comparability. In this connection I must express my respect for the way in which our American colleagues recognise and tackle not only this problem, but also the danger that the authorities will intervene with stricter regulations; I consider the Accounting Research Studies which have appeared in the last few years are particularly useful¹⁾.

In German the situation is very different. There, one has been used for many years to rather detailed legal regulations governing the preparation of annual reports. Nevertheless, I think the situation over there as regards the harmonisation of accounting principles has not been ideal. The situation as regards the form and classification of accounts may have been satisfactory, but the same does not apply to the principles of valuation and the disclosure of information in accounts. However much this situation may now have improved, I cannot judge whether the recently introduced new German „Aktiengesetz” will alter matters to any substantial and significant degree. But if the harmonisation of principles has to be brought about by legal regulations alone, I think success is doubtful.

I fear, the legal situation in the Netherlands will at first sight be found abhorrent by persons from other countries. Until now there have been hardly any legal (or otherwise compulsory) regulations as regards the Profit and Loss Account in our country; the legal regulations for preparing the Balance Sheet may be considered to be inadequate and incomplete. In general, we do not yet have any compulsory requirements for regular audits of public companies²⁾.

Now it is quite remarkable that in spite of the absence of any legal stimulus the quality of the financial statements of many companies in the Netherlands has undeniably and regularly improved, and progress in this direction has probably not been slower than in other countries. This is not to say that the situation as regards harmonisation in my country is satisfactory. Nevertheless, I venture to say that one factor which has contributed to this progress is the fact that in my country basic concepts as regards values and what constitutes profit have been developed in business economics for some time, and these have gradually and voluntarily become widely accepted in industrial circles, and have been implemented directly by accountants.

It must also be stated that the accountancy profession in my country has been rather reserved in issuing public statements about the desirable developments as regards the preparation of reports; an important consideration has been the fact that company reporting is primarily a responsibility of the management. In our country we have been able to observe that public recommendations by „Associa-

¹⁾ For example, see Accounting Research Study No. 7, „Inventory of generally accepted accounting principles for business enterprises”, New York, 1965.

²⁾ For those who require reassurance I should mention that a bill concerning the annual accounts of companies is nearly complete, and this bill remedies these shortcomings, whilst at the same time it leaves a reasonable amount of freedom.

tions of Employers" (upon whom the opinions of the accounting profession have exercised an influence) have had a noticeable effect in improving the quality of annual reporting.

Reviewing the matters mentioned above I come to the conclusion that on an international level the harmonisation of accounting principles cannot yet be regulated in detail. And the more national legislation goes into details (which is, unfortunately, the case in many countries) the more international harmonisation becomes difficult. Comparative studies such as the one which was started a few years ago in the European Economic Community³⁾ are particularly useful and certainly have their place in aiming at healthy harmonisation. However, we must be on our guard against the academics of the E.E.C. and we must voice our objections against the issue of detailed regulations which would no doubt create little more than a facade of harmonisation.

III. Causes of slow progress in harmonisation

Before considering these causes it may be useful to state that for making industrial comparisons much more is wanted than a standardised form of accounts. I mention the following aspects only (without pretending that they are complete):

- the basis of valuations (including the ways in which costs are allocated) must be identical;
- the state of affairs with respect to maintenance, research, new projects, etc. must be taken into account;
- differences in the management structure of the organisation and the methods of manufacture must be taken into account;
- differences in the nature and quality of the goods produced must be taken into account.

Without bringing these factors into the comparisons one is running a great risk of arriving at incorrect conclusions.

It should, therefore, be generally accepted by our colleagues in the profession that absolute uniformity in annual accounts is no more than an illusion (as is uniformity in many other respects) as well as being both unnecessary and undesirable. What we all want is harmonisation of the broad basic principles. How is it that the tempo in which this is being done is so relatively slow? Let us try to trace the reasons why and it may perhaps give us an indication of the way we should follow.

1 The economic realities are so complicated that they are difficult to cover by strict rules and regulations. Changes in economic circumstances are often so rapid that even if the rules were efficient at the time when they were introduced, they would quickly become obsolete.

This means that we should not aim at comprehensive and inflexible regulations but at broad, generally applicable principles which would leave space for flexibility in the application of those principles whenever the situation demanded it.

2 As regards the method of harmonisation, it seems worthwhile to look at a method which is considered obvious by some, namely strict regulation by the

³⁾ Compare: „Document de travail en matière de Bilans, Comptes de pertes et profits et problèmes annexes du Commission de la Communauté économique européenne”, Direction Droit d'établissement et services, Brussels, 1965.

authorities. The Dutch profession, fortunately, has had little experience in this matter in its own country; but they have the impression that in countries where harmonisation - and in general the quality of financial reports - are mainly dependent on regulations by the authorities this has not proved to be a good thing. I believe - and I would think that this is the almost universal view of my professional colleagues in the Netherlands - that regulation by the authorities can be a dangerous and inefficient instrument when used too extensively. That it will inhibit international harmonisation will be obvious. In cases where national regulations are incompatible, international harmonisation will have become impossible. But the dangers are also more general. I am convinced that compulsion by the authorities as regards details of accounting procedures leads to a reduction of the standards of financial reporting and forms a hindrance for development in the right direction. Detailed government regulations, as we can see, are all too inclined to prescribe elaborate, categorically classified specifications with sometimes useless details which do not give any insight into what is of real interest, namely the functional structure of the company and the sources of profit. The latter details are not, however, suitable for detailed regulations on account of their great variety.

Regulations by the authorities should, therefore, be restricted to general guiding principles and should deal mainly with the framework of financial reporting rather than with compulsory rules, for instance, of valuation. The more elaborate and precise the regulations are, the more loopholes there will be and the greater the danger - for our profession too - that more attention is paid to the interpretation of legal regulations than to looking for the correct state of affairs.

In rejecting too stringent regulations by the authorities another factor is that in the interests of a company it should be permissible for it to maintain its information in a form that is useful for its own management purposes and it should not be compelled to provide information which has no significance but creates plenty of additional work.

And finally, the prime responsibility of the management for company reports makes it desirable that it should be possible to deviate from regulations in cases where the essential interests of the company might be harmed.

3 It appears to me that another reason can be shown for the unsatisfactory progress in the harmonisation of accounting principles. I am of the opinion that too little has been based on theoretical - or, if you prefer, generally formulated - starting points and too much has been based on existing practices and has therefore become *cassavistic*.

With regard to financial reporting there are various problems as regards the methods of presentation, classification, etc. But these are of secondary importance compared to the problems of valuation. There we encounter directly the two most important questions, namely the amount of the company's net worth and the profit. In order to bring about some harmonisation in this matter it is first of all necessary to obtain a clear picture with regard to the basic concept of profit (or net income). In this matter there is not yet sufficient unity of ideas in international circles.

IV. Provisional conclusions

1 Harmonisation of accounting principles, certainly on an international level, is

a long-term question. The professions in various countries render a greater service to such harmonisation when they take delaying action against national authorities who are creating detailed regulations, than when they are demanding such regulations. A demand for more regulations, furthermore, will not make the place of the profession in the economy any more influential; most probably the opposite is true.

2 In the short run, the profession can better use its influence by direct persuading trade and industry to disclose more in their financial reports.

The object of harmonisation, we would have thought, is to achieve comparability. Undoubtedly this means harmonisation on a high level so that not only comparability in financial reporting is brought about but also the quality of reporting is improved. Even without making much progress in harmonisation, both objects would be served to a considerable extent by a greater disclosure in financial reporting. What is needed is more information as regards the way in which figures have been arrived at and what the figures do (or do not) represent. We must rid ourselves of meaningless information such as „valued at cost price or lower, valued carefully, etc.". The same applies to information about provisions given without indicating the extent of these provisions. We must realise that such meaningless information can easily be coupled with detailed data which appear very impressive but do not make any real contribution to the reader's judgment.

Let me try to give a short description of what I should like to see disclosed:

- a. Representation of the net worth of the company or the concern⁴). I will revert to this again later but it may be sufficient here to state that in my opinion this requires the application of current values of assets and liabilities.
- b. Such a classification and analysis of assets and liabilities, together with additional information, as is sufficient to give a general understanding of liquidity and solvency.
- c. Such an analysis of the results of the company or the concern⁴) and such a description of the principles of valuation used as would show the real return on the company's net worth referred to above. With regard to the analysis of the results, a first requirement is the separation of normal trading results in the period under review from non-recurring results and results of previous periods⁵).

As a further minimum of information I should want to disclose: an indication of the extent of the turnover (either by stating turnover in absolute figures or by indicating the relevant ratios with regard to previous periods) as well as the amount of taxes levied on the profit relating to the period covered by the report. In my opinion this implies - amongst other things - the necessity to equalise tax provisions. With regard to the principles of valuation, it must be admitted that a general description is not sufficient. The data stated must be such that the consequences of the method of valuation adopted can be assessed. It is implicit

⁴) This implies providing group accounts in the form of consolidated figures or in a different way.

⁵) Of course this does not mean that financial statements can give an insight into future profitability; however, they should give a picture, as fairly as possible in view of the given characteristics of the data, of the trend of past results and consequently, together with other factors, some indication of the future results.

that alterations in the stated principles, the reasons for the alterations, and their financial consequences must be stated.

3 The question of disclosure of the principles of valuation applied is all the more urgent when we realise that even complete harmonisation of accounting principles does not necessarily lead to comparability.

Let me mention as an example the depreciation of fixed assets. Even if the system of capitalisation and depreciation is the same in two companies, the depreciation charges (and therefore the net results) are not comparable if the rates of depreciation differ. And nobody would wish to go so far as to harmonise such rates by means of government regulations. At least a disclosure of the rates and bases would in this case assist comparability.

A very important cause of the absence of comparability even in cases where there is a high degree of formal harmonisation of principles can be seen in the changes in the value (of assets) in the course of time. I do not have to refer to the most important cause (inflation). But it may be necessary to mention the following. Financial statements based on prices which were paid at different times in the past are not comparable as they have not been reduced to the same denominator. The prices have naturally varied according to the times of acquisition. And the lack of comparability applies not only to the case of comparisons of financial statements of various companies in one country at the same moment (and in the case of comparison of reports of various companies in various countries; in addition there is the disturbing influence of the difference in tempo of alterations in monetary values in those countries) but, even more difficult, also in the case of comparison between successive financial statements of one company over the course of time.

In this question - that of the influence of fluctuations in value over the course of time on the financial reports - I see a problem of the first order for our profession. I realise thereby that there is a risk of becoming boring to visitors at international accountants congresses, for this sound has been heard from the Dutch side at several previous congresses. But the problem has certainly not become less real. In this connection I can only advocate that representation of net worth as well as determination of the results must be on the basis of current values; and also that the requirement of fairness of financial statements as individual documents goes hand in hand with the requirement of comparability with financial statements of other companies. Comparability obviously requires comparable values; and the latter are only comparable when reduced as much as possible to the same denominator.

I dare not say that we have solved this problem in the Netherlands but I can say that significant advances have been achieved in its practical application, and further developments are going on; and all this on a voluntary basis. This fact should be stressed in order to explain the rejection by most Dutch professional colleagues of stringent regulations on this subject by the authorities. The experience in various countries close to us shows that whenever the law intervenes with the principles of valuation, usually only the principle of historic cost is allowed, which precludes any further development in the direction of current values.

4 With regard to the procedure to be followed in order to achieve greater

harmonisation of accounting principles the following may suffice. It should be considered whether, in view of the fact that the primary responsibility for financial reporting rests with the management, the making of public recommendations (exclusively by accountants) is at all efficient. It seems to me better that studies should be made and recommendations based on this should be made jointly by accountants and „Associations of Employers” (as representatives of the management), possibly together with representatives of more general financial interests (such as for instance Stock Exchanges and associations of share-owners).

5 Further thought is necessary as regards the basic concept of profit. I shall try to submit some subjects for discussion in the following part of this paper. It goes without saying that there can be no question of it being complete.

V. The concept of profit (first part)

1 The basic functions of profit are:

- a. to be a yardstick for the efficiency of production, and for the capacity of the company to obtain a normal return for the use of its own capital. This yardstick is not only indispensable for the management but also for our entire economic system, as profit - in the long run - has a function in distributing the permanent capital amongst all companies.
- b. to form the basis for the spending (withdrawal from the company) by those whose income depends on the results of the company (principally but not exclusively the owners of the company). The nature of the profit is that it can in principle be distributed and spent without affecting the purchasing power of the company's net worth (at the beginning of the accounting period). Whether the profit is actually spent or whether it is partly or entirely retained in the business are other questions, not affecting the nature of profit.

For both functions one concept of profit should apply, i.e. the amount of the profit is the same for both purposes, although the required knowledge of details concerning the composition of the profit can vary according to function. The function of the yardstick for the management demands far more detailing than the second function, although in this case knowledge of some details is also necessary, for instance knowledge concerning the normal and non-recurring elements of the profit in order to enable one to project a rational pattern of future spending.

2 The problem of profit determination consists of two basic parts:

- a. the nature and extent of the profit;
- b. the allocation in time: when is the profit earned and to be recorded?

3 I shall deal very briefly with the subject under b. above before discussing (in § VI) the matter mentioned in a.

The problem is: what criterion (or what criteria) indicate(s) in what period the profit has to be shown? This problem results from the fact that financial periods are only artificial dividing lines between series of transactions which in fact are inseparably connected with each other. At the end of each period there are unfinished transactions which have to be valued (mainly fixed assets and invento-

ries⁶⁾. And this applies in principle for both sides of the transactions; the cost as well as the proceeds.

The critical moment (at least in the economic system of free enterprise) is generally the moment of exchange. This is the moment when the price is fixed, the proceeds become known and therefore the result of the transaction is determined in principle.

That the exchange should be the critical point in the determination of profit and form the condition for profit taking does not, however, mean that the profit results from the exchange. The exchange is the final act of a process during which the profit has, as it were, been ripening and it is for this reason the critical moment. But the process of ripening must already have taken place; the company must have exercised its function, that is to say must have manufactured the exchanged product.

There are, therefore, two criteria: the exchange must have taken place and the goods (or services) to be exchanged must have been produced, i.e. delivered in the form, place and time as agreed.

And now some words about losses. These are not in every respect the opposite of profits. The difference is that here the exchange does not form a critical moment. Profits are (in general) ripe not earlier than at the moment of exchange; losses, on the other hand, are present from the moment that it must be expected that the exchange will show a loss. This is rightly recognised in the old and well known commercial usage of valuation „at the lower of cost or market value” („Niederstwertprinzip”).

VI. The concept of profit (second part)

1 Finally, I have to venture some remarks concerning the nature and extent of profit. I should say at once that I do not pretend to add to the existing theories of profit. However, I wish to draw attention to what I have previously called the most urgent general problem in the determination of profit, namely the influence which fluctuations in value must have. This is not because no attention has been paid to this in our profession. I have looked up the reports of the last three international congresses of accountants; at all of them this subject has been discussed. But I think that it must stay on the agenda because too little effort has been made by accountants in the direction of practical solutions.

The profession in general, as far as I can see, is far too wedded to the idea that prices paid in the past form such a safe and fixed basis for financial statements and the audit thereof, whilst in fact this basis is only seemingly safe and fixed and may be really a quicksand. What I should like to see is a wider understanding that as a result of fluctuations in value there can be alterations in the company's net worth which represent neither profit nor loss.

Let me add two further remarks. First, from the Dutch side the theory of replacement value has for some considerable time been put forward as a basic theory

⁶⁾ Also the important problems with regard to allocation in time of costs of maintenance and research fall essentially within this category.

for the determination of profit⁷). The essence of this is in my opinion the above mentioned idea that changes in the net worth can occur which do not represent profit or loss. The fact that recognition of this idea by accountants (and the practical application by business) outside the Netherlands is only so relatively slight has naturally several causes but possible one of them may be the fact that we have made the question somewhat too complicated as well as the fact that we may have left certain questions unanswered. I am putting it like this because what I shall say in the last part concerning the concept of profit cannot be considered an explanation of the („classical”) theory of replacement value. But my attempt to give a simple basic formula for the concept of profit does owe much to the underlying idea of this theory.

Furthermore, I should like to mention the fact that I am impressed by the attention given by our professional colleagues in the U.S.A. in the last few years to the question under discussion and the growing conviction in that country „that it is unrealistic to ignore fluctuations in the value of the currency”. I am thinking in this connection of publications such as Accounting Research Study No. 6 of the A.I.C.P.A.⁸) to which my ideas are related.

2 As regards the definition of the concept of profit the two most important requirements appear to me, to be the ones of practicability and neutrality. By neutrality I mean the absence of specific aims which would have to be achieved. As soon as one wishes to introduce these one gets stuck in the multitude of aims which are possible. Therefore: no maintaining of the relative place of the company, no maintaining of the flow of income or of the production capacity, etc. One should restrict oneself to the basic idea of what profit should indicate, namely what part of the total growth - during the period under review - of its net worth can be principally taken away from the company for spending. In this connection I can really only see one standard which can be deduced directly and primarily from the economic principle and that is the real net worth which was present in the company at the start of the period⁹).

What matters now is what should be understood by this net worth. It is general overall purchasing power, power of control over goods and services. We are expressing this purchasing power in money in its capacity as a unit of account. This standard is inadequate, for these monetary units do not possess the same purchasing power over the course of time. When we are talking of real net worth as a standard for determining the profit over a period we can no longer

⁷) In this connection we must mention the name of Prof. Dr. Th. Limperg Jr., whose ideas have had a great influence in the Netherlands in the accountancy profession and also, although to a smaller but still significant extent, in trade and industry. The principles of the theory of the replacement value as well as a practical application (at Philips' Gloeilampenfabrieken N.V.) are clearly set out in the article by Prof. A. Goudeket „An application of replacement value theory”, Journal of Accountancy, July, 1960).

⁸) „Reporting the financial effects of price level changes”, New York, 1963.

⁹) This does not answer the question as to whether when formulating the concept of profit one should approach the problem from the point of view of the persons who have put capital into the company or from the point of view of the company. This question would find its origin in the fact that companies have grown into independent entities which then lead their own lives, quite separate from the owners of the capital. I consider this, however, an irrelevant problem in relation to the determination of profit; the question - and therefore the reply to the question - is the same from both points of view. The points of view will differ only in a next phase, which is not discussed here, namely the one of distribution of profit.

mean the *nominal* capital and reserves, expressed in monetary units, which at the end of the period have a purchasing power differing from that at the beginning of the period. What is relevant is the *real* net worth, the capital in the sense of general purchasing power of goods and services. This must have been preserved in order to show a consumable surplus, a profit.

Profit is, therefore, every increase in the real net worth (in so far as it is created inside the company, and not from fresh capital). And this means that we cannot determine profit before having decided what should be the extent of the company's net worth at the end of the period so as to leave this equal in purchasing power to the real net worth at the beginning of the period. Putting it in a different way: first the fluctuations in the general price level should be eliminated by means of indexing of the company's net worth; afterwards any remaining surplus is profit and any deficit is loss.

In principle this is only the old commercial usage of calculating the profit by comparing the capital at the beginning of the period (or before the transaction) with the one at the end of the period (or after the transaction). However, the remaining surplus (or deficit) is not now simply arrived at by comparison of nominal, historical amounts of capital. The influence of fluctuations in the value of the money (that is in the general purchasing power of the monetary units in which the capital and the other accounts are expressed) has to be eliminated. It is not, therefore, the fixed assets and inventories which have to be maintained (upon which in my opinion the „classical“ theory of replacement value has concentrated too much) but the purchasing power of the company's net worth.

Naturally, according to this view the valuations of all assets on the basis of current values remains a necessity; no longer, however, as a purpose in itself¹⁰) but as a means, as it were, as an intermediate phase to arrive at the real purpose which is the determination of the growth or of the reduction in the company's real net worth.

If the revaluation of assets (and in some cases the liabilities) at current values shows an amount (whether positive or negative) which is the same as the amount that has to be added to the net worth at the end of the period in order to maintain the purchasing power of the latter compared to the net worth at the beginning of the period, this means that there is neither a profit nor a loss under this heading. Whatever the revaluation shows as an increase or a reduction (i.e. more or less than is necessary to maintain the purchasing power of net worth) is in principle a profit or loss¹¹).

It still remains necessary of course to analyse the profit according to its origins. The results of revaluation on the above basis must therefore remain strictly separate from the results of normal day to day business transactions.

The essential points have now been mentioned. What follows now is a little elaboration. The fact that one should be careful in determining profits arising from revaluation as referred to above (these are not, therefore, the amounts of the revaluations themselves but only those parts of the amounts of the revaluations that are not necessary to maintain the real net worth) is an obvious but, in principle, a

¹⁰) That is to say: for determining the profit; the use of current values has in addition as direct object the fair representation of net worth.

¹¹) As regards this kind of profit, the problem of time allocation dealt with in paragraph V naturally continues to exist.

different question. Also the argument that any growth in the net worth which would result from this revaluation could not be a profit because this growth is retained by the company with its productive capacity, is not, in my opinion, a valid one. Such an argument is the result of too technical an approach, instead of an economic one. It is based on the idea that as long as the means of production remain the same in quantity, there is nothing to consume and therefore there is no profit either. But I am of the opinion that, from an economic point of view, the situation in question is a different one, namely one of expansion of the company in an economic sense. As „normal” profits of day to day trading transactions are invested in the same period in which they were achieved, and can therefore no longer be paid out but have not yet lost their consumability in principle, so the profit from revaluation can be seen in the same light.

Let us go into this a little further. We have already concluded that there is no question of profit if the increase in the current value of the assets is the same as the growth of the net worth of the company which is necessary to maintain the real net worth. In that case the result of my argument is exactly the same as the one of the „classic” theory of replacement value. Which causes can create an excess¹²⁾? These are the following:

- the prices of specific goods (non-monetary assets) of which the company keeps stocks are rising faster than the general price level (or rise when the general price level remains the same or fall to a lesser extent than the general price level);
- the liabilities exceed the monetary assets (or, to express the same point in a different way, the non-monetary assets exceed the company's net worth).

As regards the first cause (let us for the sake of simplicity suppose a rise of specific prices whereas the general price level remains unchanged), I consider it obvious that in an economic sense there is a question of expansion of the company. I consider in this case that only the total economic position is relevant and that - for our problem - it does not matter if the company expands because after starting from a position of 100 pieces with a value of 10 each, arrives at a position of 120 pieces of 10 each, or at a position of 100 pieces with a value of 12 each (all this at a general price level which remains unaltered). This also means in my opinion that the growth in value of 2 units can, in principle, be distributed. In this case there will probably be other reasons to maintain the quantitative position at the same level so that one will either reserve the profit or take up outside capital in order to finance the distribution of profit. In the latter case there could be financial objections but this does not affect the profit character of the growth in value in question.

It may also be interesting to consider the macro-economic side of the situation mentioned. A specific increase in price is the expression of an additional significance given to the commodity in the economy and is a result of the increase of its relative scarcity. At an unchanged general price level the prices of other goods must become lower, in total by exactly as much as the specific price increase absorbs in purchasing power. There will now be undisturbed economic circulation if the flow of purchasing power in total remains unchanged. In the companies where no specific price increase has occurred a reduction in real net worth has

¹²⁾ Or a deficit, in which case the argument runs parallel but in the opposite direction. The two causes mentioned are working together; they can reinforce each other but also oppose each other. What matters is the net influence of both forces. A very simple example is given in the appendix to this article.

taken place as a result of the above price reductions. This is a loss, a reduction in purchasing power. When the company in which the specific price increase has occurred calculates its profit according to the „classic” theory of replacement value, the rise in value (which has led to the increase of the real net worth) is not treated as profit, and consequently a compensating increase in the flow of purchasing power does not take place.

This is not right because neither the total net worth nor the total production has fallen. Against the calculation of loss in companies without the specific price increase, should be put the calculation of profit in the company with the specific price increase. In this way the economic circulation remains constant and no disturbance will occur.

Mutatis mutandis it can be argued that the same occurs in the situation where the non-monetary assets exceed the company’s net worth and the increase in value is greater than the amount necessary for maintaining the company’s real net worth.

However, let us not be distracted by the above excursion; in the end, profit-making by production and exchange is normally the main purpose of the company and not the making of profit out of price changes. And *our* main purpose is to promote the fair assessment and presentation of the results of production and exchange. As an essential condition for this (as well as for a fair representation of real net worth), we have seen that the financial statements have to be based on current values. Let us abandon the idea that any fluctuation occurring within the company in its net worth can be considered as a profit or loss. The accountant who is feeling secure on the basis of historical cost is in reality creating an illusion, namely by creating in times of inflation apparent profits and in times of deflation, which may perhaps return one day, apparent losses. And the economic consequences of the latter are perhaps even more evil than of the former.

3 I should like to make a few final remarks:

- a. So far as this may not already be obvious, I should like to suggest that the formulated concept of profit should be independent of the direction of the alteration in the (general) price level. This implies that at a falling level of prices (deflation) one cannot introduce the additional necessity for maintaining the nominal capital.
- b. Concepts such as the general price level and the purchasing power of money, are not exactly definable quantities. But this consideration is not important for our purpose which is determining the profit as fairly as possible; this will remain always only an approximate determination. In many countries a useful index is available. I am thinking for instance of the „Gross National Product Implicit Price Deflator” in the U.S.A. and the „Price index number of the National Income” in the Netherlands.
- c. An objection often heard against the application of current values, namely the elaborate aspect of it, is not realistic. Experience in companies which apply these values show that there is no real problem here. Administrative techniques have been developed in such a way as to make a rational procedure possible.
- d. An objection heard even more often is that it is very difficult to fix current values (if you like: replacement values). There is seldom technically identical replacement. I do not deny that this can be difficult in a number of cases (not, for instance, where the alterations in the technique are not particularly fast;

nor with quickly circulating assets such as stocks), but I do not consider them impossible to solve. Let us not forget that perfection in the determination of profit cannot be achieved on other points either; in any case, it is not necessary for achieving the purpose of the assessment of profit. The management must also deal with such questions at other moments, e.g. estimating the economic useful life of fixed assets for the purpose of depreciation; when deciding at what moments fixed assets must be replaced before being technically worn out on the ground of greater efficiency of new assets.

Moreover, one should remember that the problem in the previously outlined concept of profit is possibly simpler than in the „classical” theory of replacement value. In the latter theory when talking of economically identical replacement the point is the value of goods that have to replace the present ones. The point in the concept of profit formulated in this paper is the current value of the existing goods. But I wish to end by stating that in essence my object is the same as that of the theory of replacement value, which is: to prevent what is „return of capital” from being presented as „return on capital”.

APPENDIX

Position at the beginning of the period:

| | | | |
|--|----------------|----------------------------------|----------------|
| Inventory | | Net worth (capital and reserves) | 120.000 |
| 150.000 units at 1.- = | 150.000 | Liabilities | 80.000 |
| Monetary assets (cash, receivables etc.) | 50.000 | | |
| | <u>200.000</u> | | <u>200.000</u> |

It is assumed that the inventory purchase price rises to 1.04 per unit (for simplicity's sake: immediately after the beginning of the period). The general price level rises with 6%. 300.000 units are sold at 1.25 and replaced.

The position at the end of the period then is:

| | | | |
|-------------------------|----------------|---|----------------|
| Inventory | | Net worth: | |
| 150.000 units at 1.04 = | 156.000 | Beginning of period | 120.000 |
| Monetary assets | 63.000 | Increase to maintain its purchasing power | 7.200 |
| | | | <u>127.200</u> |
| | | Profit | 11.800 |
| | | | <u>139.000</u> |
| | | Liabilities | 80.000 |
| | <u>219.000</u> | | <u>219.000</u> |

The profit is ascertained as follows:

| | |
|---|---------|
| Sales 300.000 units at 1.25 | 375.000 |
| Cost of sales (replacement cost) 300.000 units at 1.04 | 312.000 |
| | <hr/> |
| | 63.000 |
| Expenses | 50.000 |
| | <hr/> |
| Trading profit | 13.000 |
| Increase net worth in order to maintain purchasing power (6% of 120.000) | 7.200 |
| Of which covered by revaluation of inventory (150.000 at -.04) | 6.000 |
| | <hr/> |
| | 1.200 |
| | <hr/> |
| Net profit | 11.800 |
| | <hr/> |

Calculation on basis of historic prices would have resulted in a profit of 19.000 (sales 375.000 less cost of sales 306.000 less expenses 50.000).

Calculation on basis of replacement value without taking into account maintaining real net worth would have resulted in a profit of 13.000.