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**Inflation - Adjusted Accounting and Corporate Value  
Redefinition: Fixing Nigeria Investors' Challenge**

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**Abstract**

*In many countries, including Nigeria, the historical concept is adopted in the recording of financial transactions. Convenient as this approach suggests, in times of generally rising prices, the purchasing power eroding effect of inflation is over-looked. This ought not to be so, considering the tendency to*

*speculate pseudo-values which eventually undermine corporate competitiveness. This paper, therefore, addresses the twisty advocacy and seeming intricacy of Inflation-Adjusted Accounting Systems (IAAS), with a view to illuminating the translational hurdles. The results abundantly necessitate the expeditious consolidation of a more robust framework to fix impending inhibitors such as lack of awareness, inaccessibility of relevant standard indices, resistance to change, and absence of professional pronouncement by the Nigerian Accounting Standards Board (NASB). Nigeria and other developing/emerging economies should do well to domesticate value-driven financial reporting systems in line with global best practices, to reinvent corporate governance and boost competitive advantage.*

**Key Words:** Books' looks, financial analysis, Inflation Accounting, Nigerian investors

### **Introduction**

Accounting is defined as the process of identifying, measuring and communicating economic information in order to permit informed judgments and decisions by the users of the information (American Accounting Association, 1977). For information to be useful, it should characteristically possess relevance, comparability, completeness, accuracy, timeliness, objectivity and accessibility. In times of rising prices, information generated by the accounting process through Historical costing suffers severe limitation (lacks relevance and comparability) and this renders its decisional usefulness/validity doubtful. Information that recognizes the effect of rising prices (inflation) and consequent loss in purchasing power of money is obviously more relevant in meeting investors' and allied users' decision-making needs.

Thus, financial statements prepared under the Historical cost approach do not properly reflect business performance in times of rising prices. This is the critical concern of this study. Given the import, two variables come into play. The first is corporate financial performance (CFP); while the second is Accounting Information System (AIS). Essentially, the study examines to what extent various reporting systems, including inflation-adjusted accounting system (IAAS) are adopted or not; and to identify possible reasons for non-adoption. The study analytically illuminates the looks of firms in the books under historical accounting compared to Inflation-adjusted accounting. In Nigeria, HCA has remained dominant over the years, as no

other system has so far been conscientiously adopted. In line with the research purpose, the elicited hypotheses are:

Ho<sub>1</sub>: There is no significant relationship between lack of awareness and non-adoption of IAAS.

Ho<sub>2</sub>: There is no significant relationship between inaccessibility of relevant standard indices and non-adoption of IAAS.

Ho<sub>3</sub>: There is no significant relationship between resistance to change and non-adoption of IAAS.

Ho<sub>4</sub>: There is no Significant relationship between absence of professional pronouncement and non-adoption of IAAS.

### **International Accounting Standards and Inflation Adjustment**

Issues relating to International Accounting Standards (IAS) have been on the front burner of scholarly accounting discourse in recent times. The focal perspectives border on antecedents, processes and outcomes influencing the adoption of a commonly accepted set of accounting standards (Ola, 2001; Schroeder and Clark, 1995). The antecedents comprise:

- Economic issues, having to do with stage of development, inflation and financial markets;
- Political issues, having to do with system stability;
- Legal issues, having to do with financial reporting and general business laws; and
- Cultural issues, having to do with values, educational systems, religion and language.

The dominant processes comprise:

- Accounting practices, having to do with transparency, accountability, and disclosure requirements;
- Standardization efforts/effects; and
- Motivation to harmonize and exchange controls.

The key outcomes comprise:

- Quality of financial reporting

- Adoption of explicit accounting standards
- Investment decisions,
- Access to global capital markets,
- Economic welfare, and
- Corruption controls.

Furthermore, accounting diversity among societies is reflected in financial statements prepared under different accounting standards. In the circumstance, if investors and creditors encounter difficulties in understanding financial statements, they would be reluctant to invest or lend funds to such companies. It is therefore, imperative for financial reports to be written in common accounting language that is understood globally (Pacter, 2002). Standardization efforts date back to the late 1950s, and since then, the work of accounting and non-accounting organizations and culminated in the setting up of International Accounting Standards Committee (IASC) in 1973. Some decades after, the structure was changed to bring about convergence between national accounting standards and practices and high quality global accounting standards (Choi, 1999). It was eventually renamed International Accounting Standards Board (IASB) and given full responsibility for promulgating International Accounting Standards (IAS).

The expectation is that principles which are based on global accounting standards would be pursued as key to opening the door to the world's capital markets. An international set of accounting standards should pave a more level playing field for income statements and balance sheet ratios to be more consistent between competing companies (Anderson, 2003). This is a strong and compelling case for adoption of IAAS. The current position on inflation accounting is represented by International Accounting Standard No. 15 as released by the International Accounting Standard Committee (IASC) in 2000. The IASC recognizes three basic approaches to inflation accounting viz:

- General Purchasing Power Approach,
- Current Cost Accounting Approach, and
- Hybrid Approach.

Harvey and Keer (2001), drawing from International Accounting Standards (IAS 15), submit that financial information on changing prices is reported in

various ways, with the above specified approaches being dominant. Under the general purchasing power approach, income is recognized after the general purchasing power of the shareholders' equity has been maintained (in line with the concept of financial capital maintenance). Some or all items in the financial statements are restated for changes in the general price level, using an appropriate index. Also, income normally reflects the effects of general price level, charges on depreciation, cost of sales, and net monetary items. Under the CCA, replacement cost of an asset is used as the primary measurement basis. Income is recognized after the operating capacity has been maintained (in line with the concept of physical capital maintenance). It is note worthy that CCA method:

- Generally requires recognition of the effects of changes in prices on depreciation and the cost of sales, and
- Usually requires the application of some form of adjustments that have general recognition of the interaction between changing prices and the financing of an enterprise.

Conceptually the hybrid approach, being characteristically eclectic, combines the features of CCA and CCP. The financial information at the centre of all these is sometimes provided using the various methods described above, either in primary or supplementary financial statements. However, there is no international consensus yet, on these because redefinitions (developments and improvements) are evolving. Business organizations strive to harness basic financial statements for periodic corporate performance analysis. The income figure, represented by net investment ratio, is a widely accepted indicator of corporate progress/success or an early warning signal (EWS) of failure. Nonetheless, expert financial analysts are not satisfied working with a single profit figure alone. It is the profit in the next financial statement and the one after it that matter. The past figure is useful as a predictor of the future ones, but in order to predict the future, one past figure is not enough. A series is required, and more so, trends have to be captured. Thus, assessing the profitability of an individual business, and of businesses in general, could be changed radically by the choice of accounting method (Whittington, 1997).

ROE, for instance, measures the adequacy of return to the shareholders. The decision making process involves a determination of whether to buy, hold or sell their equity interests in an outfit. By comparing the returns with those from possible alternatives, the shareholder is better guided in reaching his

final judgment. Going with the economists view, income does not arise until capital has been maintained intact. In inflation accounting, equity is maintained either in terms of shareholders' purchasing power (the proprietary view), or in terms of the operating capacity of the firm (the entity view). ROA is another plausible measure considered by analysts. Assets are economic resources owned by the business. Since ROA measures returns on these assets, the value at which the assets are stated becomes very fundamental. If ROA is below industry average, the company will consider increasing profitability or reducing asset base without adverse consequences (Nwaeke, 2005; Agundu, 2010).

In inflation accounting, the asset base is usually adjusted by inflation index (the CPP) or presented to reflect current values (in line with CCA). The World Bank constructively encourages national regulators to accept the IAS rather than developing their own country specific practices. This is in view of the wide acceptance of IAS and flexibility in inculcating global best practices. The World Bank also accepts IAS as basis for the preparation of financial statements received from borrowers on the use of bank loans and credits. Specifically, IAS 15 guides the process of reflecting the effects of changing prices generally, while IAS 29 guides financial reporting in hyper-inflationary economies. Against the backdrop of time-value dynamics, financial statements prepared on HCA basis do not realistically present a true and fair view of corporate financial performance or future potential, if capital is not being maintained. Actual assessment of performance through ratios such as return on capital (ROC) is meaningless, if profits are overstated, capital is undervalued, and assets are valued under mixed conventions (Agundu, Nwanyanwu and Ohaka, 2008). Consequently, the interfacing adjustments to HCA should relate to:

- *Costs of sales:* The objective is to calculate the current cost of goods sold during the period at the actual or weighted date that the sales occurred, so that net profit is reduced by this adjustment;
- *Depreciation:* The core of this adjustment is that the depreciable amount of property, plant and equipment be adjusted to current value, so that depreciation charge for the period is based on this value and net profit is reduced by this adjustment; and
- *Gearing adjustment:* This adjustment is based on the manner in which the non-monetary assets are being financed in an entity. External resources are used to partially finance the cost of

replacement of non-monetary assets (as it is the case when monetary liabilities exceed monetary assets and no loss in purchasing power is suffered by the owners). The net monetary liability position enables the entity to finance a portion of non-monetary assets, which neutralizes a portion of the costs of replacement of inventories as well as property, plant, and equipment; and net profit is increased by the adjustment.

If monetary assets exceed monetary liabilities, then all costs of replacement of inventory and property, plant, and equipment as well as the net portion of monetary assets are financed by equity. This has negative effect on net profit because of loss of purchasing power of the monetary assets borne by the owners. Given that the adoption of IAAS gives a clearer view of operations of businesses, its non-domestication in Nigeria and some other developing/emerging economies is not healthy for corporate governance and competitive advantage.

### **Methods**

The study population comprises the entire membership of the Institute of Chartered Accountants of Nigeria (ICAN), estimated at 25,000 and contained the ICAN Membership Handbook. ICAN members were chosen because they were considered knowledgeable in this subject area. The sample size, based on the Krejcie and Morgan sampling Table, is 379. For geographic spread, quota sampling is appropriately adopted along the four high-brow metro-lines of Nigeria, comprising Abuja, Ikeja, Kaduna and Port Harcourt. ICAN members in these District Societies form the sample subjects. Accordingly, each ICAN District Society has a quota of 25% (that is 95), except Abuja which has the balancing 94. This also highlights the administration of research questionnaire across the geographic scope. The field work recorded net retrieval of 308 copies, representing 81%, with details in Table 1:

**Table 1: Research Question Administration**

<b>Zone</b>	<b>Copies Distributed</b>	<b>Copies Returned</b>	<b>Copies Rejected</b>	<b>Copies for Analysis</b>
Port Harcourt	95	75	5	70
Abuja	94	64	5	59
Ikeja	95	95	=	95
Kaduna	95	91	7	84
	379	325	17	308
%	100%	86%	5%	81%

*Source: Field Data (2010)*

## Results

The 308 useful copies of completed questionnaire constitute the base statistic for analytical purposes. The respondents are profiled in terms of membership status, employment sector, number of years in employment and number of years in professional practice, as shown in Tables 2, 3, 4 and 5:

**Table 2: Respondent's ICAN Membership Status**

S/N	District	Associate (ACA)	Fellow (FCA)	Total
1	Port Harcourt	52	18	70
2	Abuja	51	8	59
3	Ikeja	81	14	95
4	Kaduna	61	23	84
	Total	245	63	308

Source: Field Data (2010)

**Table 3: Respondent's Employment Sector**

S/N	Sector	Frequency	Percentage (%)
1	Manufacturing	24	7.79
2	Services	59	19.16
3	Banking/Commerce	32	10.39
4	Government/Parastatal	95	30.84
5	Educational Institutions	33	10.71
6	Professional Practice	65	21.10
	Total	308	100.00

Source: Field Data (2010)

**Table 4: Respondent's Years in Employment**

S/N	Years	Frequency	Percentage (%)
1	1 – 15 Years	91	29.55
2	6 – 10 Years	88	28.57
3	More than 10 Years	101	32.79
4	Not Applicable	28	9.09
	Total	308	100.00

Source: Field Data (2010)



**Table 5: Respondent's Years in Professional Practice**

S/N	Years	Frequency	Percentage (%)
1	1 – 15 Years	118	38.31
2	6 – 10 Years	44	14.29
3	More than 10 Years	51	16.56
4	Not Applicable	95	30.84
	<b>TOTAL</b>	<b>308</b>	<b>100.00</b>

Source: *Field Data (2010)*

The research hypotheses are tested using the Pearson Product Moment Correlation technique. The results relating to correlation coefficient (r) and other vital statistics are presented in Table 6:

**Table 6: Hypotheses Test Results**

Hypothesis	IAAS Inhibitors	Mean	Zcom	Zcon	Decision
Ho <sub>1</sub>	Lack of awareness	0.57	12.10	1.65	Reject Ho
Ho <sub>2</sub>	Inaccessibility of relevant indices	0.62	13.93	1.65	Reject Ho
Ho <sub>3</sub>	Resistance to change	0.23	4.09	1.65	Reject Ho
Ho <sub>4</sub>	Absence of professional pronouncement	0.60	13.16	1.65	Reject Ho

Source: *Field Data (2010) (SPSS – aided).*

Key:

r = Correlation coefficient

Zcom = Computed z statistic

Zcon = contingent z statistic (306, 0.05)

The results in Table 6 indicate that:

- There is significant relationship between lack of awareness and non-adoption of IAAS;
- There is significant relationship between inaccessibility of relevant standard indices and non-adoption of IAAS;
- There is significant relationship between resistance to change and non-adoption of IAAS; and
- There is significant relationship between absence of professional pronouncement and non-adoption of IAAS.

Among the inhibitor variables, inaccessibility of relevant standard indices and absence of professional pronouncement by the NASB are dominant, trailed by lack of awareness and resistance to change. The apparent complexity of IAAS, extra cost of processing and more time required for compliance are added disincentives.

### **Discussion**

The inflation phenomenon is not new in Nigeria and other emerging economies of the world. In recent years, inflation has become a more worrisome macro-economic problem in Nigeria (Gbosi, 2005; Agundu, Imegi, Maxwell and Atubokiki, 2008). The fundamental adverse effect of inflation is resultant/concomitant decline in the purchasing power of money. The major factors responsible for sharp increase in the general price level in Nigeria include global economic crises, inconsistency in macro-economic policies, fiscal deficits, financial sector distress, acute depreciation of the Naira exchange rate and perennial scarcity of petroleum products. Nwaeke (2005) contends that astronomical rise in the general price level in the Nigerian economy, consequently make nonsense of the accounting process. Also, depreciation provisions become mere mockery and utterly defective in such circumstances. As a way forward, inflation-adjusted accounting had been embraced by practitioners in many advanced economies. However, in Nigeria, sensitivity and pro-activity in this regard, remain a far cry. According to Whittington (1997), many important decisions have to be made to sustain corporate competitiveness, which are based on financial accounting. Some of the crucial ones include:

- Decision by directors of a company to declare dividends;
- Decision by potential creditors to lend to a firm;
- Decision by investors to buy or sell shares in a company; and
- Decision by shareholders to support the present management by re-electing directors.

Since the 20<sup>th</sup> century, one other increasingly important use of financial accounts has been to facilitate the establishing of basis for company taxation. In recent years, growing emphasis has been on the use of financial reports by several users of accounts other than the providers of finance. Prominent among these users are employees, who use reported profits as evidence that their employers can afford wage increases. They also use financial reports to

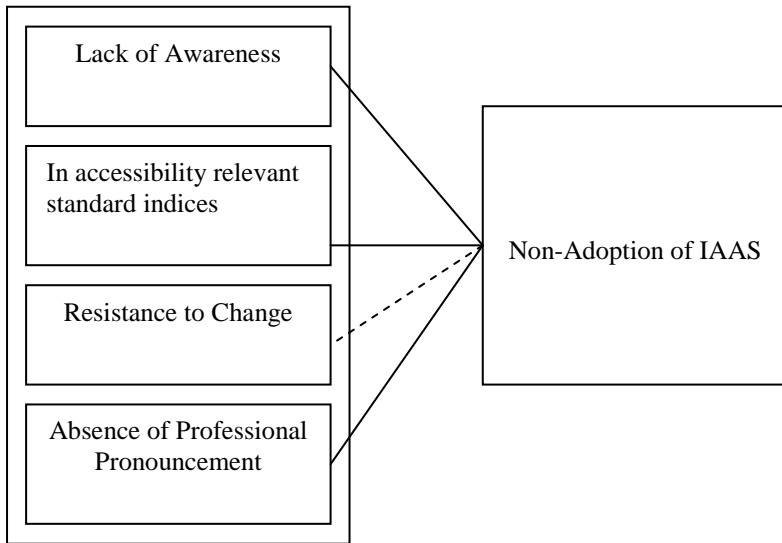
assess their future employment prospects. Government also has a substantial interest in financial accounts as providing information for economic policy decisions. Inflation dynamics (time value of money) are of the essence of these tendencies. Thus, the adjustment of financial accounts for the effects of inflation is potentially important, since it influences the levels of taxation, dividends, wages and prices. It is therefore not surprising that the debate on different methods of inflation accounting has been very spirited and heavily heated. The choice of inflation accounting technique also affects the allocation of resources, and various affected parties are strongly disposed to be supportive of a particular technique that would favour them.

The thrust of this study re-enforces the call for a paradigm shift from traditional historical accounting to a more value-driven approach. The latter professional framework is considered more realistic and relevant to the needs of various user groups in modern day business and commerce. It is also in line with the provisions of IAS 15 on reflection of the effect of price changes on published financial statements. It equally makes for compliance with World Bank recommendations in this regard. Harvey and Keer (2001) anchor the preference for value-driven accounting (especially CCA) on the critical economic realities, that:

- As prices change, values based on historic cost are less helpful in determining the worth of the enterprise;
- Profit figures result which from the subtracting of unlike figures (such as oranges from apples) have no meaning in evaluating corporate financial performance; and
- Maintenance of capital, which is measured in monetary terms, becomes futile when the value of money is changing.

It is quite instructive from this study that the prevailing hurdles and crucibles to be crossed in order to ensure meaningful value-driven compliance, border on lack of awareness, inaccessibility of relevant standard indices, resistance to change, and absence of professional pronouncement, as illustrated in Figure 1:

**Figure 1: IAAS Compliance Constraint Web**



**Key**

Very strong Relationship ( $r = 0.60 - 1.00$ )

Strong Relationship ( $r = 0.50 - 0.59$ )

Partially strong Relationship ( $r = 0.39 - 0.49$ )

*Source: Conceptualized by Authors*

**Conclusion**

In many progressive economies of the world, accounting and finance experts are unanimous in their choice of value-driven reportorial and analytical systems. This redefines the process and illuminates the effects of changing price level. The general position suggests a cautious preference for one auspicious approach, realizing that every system has delights and defects. Perrin (1976) contends that there has been overall preference for Sandiland's (1975) current cost approach, compared to other conventional alternatives.

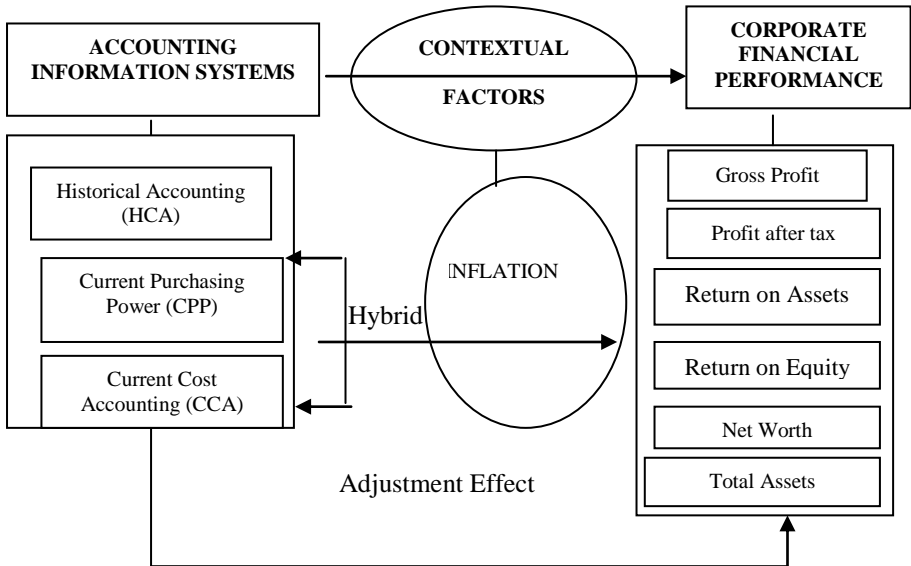
As historical cost accounting is still dominant Nigeria, the implication is that, in times of rising prices, financial/accounting information meant for scenario

analysis and strategic decision may be misleading. In effect, capital is not maintained in any form (neither in purchasing power terms nor in terms of the operating capacity of the entity). The simple assumption by affected practitioners in Nigeria is stability of the Naira, which in true and fair terms, is not tenable. Actual assessment of corporate financial performance through ratios is also meaningless as prices change. Stakeholders in emerging economies no longer find adequate help in values based on historic costs when determining the worth of an enterprise (Ola, 2001; Harvey and Keer, 2001). To expeditiously get out of the woods and odds, it is recommended that:

- Provisions of IAS 15 which advocates conscientious reflection/consideration of the impact of inflation on published financial statements be formally adopted and domesticated;
- Firms embarking on pro-compliance regimes should elect to adopt inflation-sensitive system such as CPP, CCA or hybrid framework, which combines salient features of CPP and CCA;
- NASB, in collaboration with ICAN and other recognized professional accounting bodies in Nigeria, should float sustainable instructional schemes to fix the non-compliance perpetuating factors, manifest as lack of awareness, inaccessibility of relevant standard indices, resistance to change and absence of professional pronouncement; and
- Appropriate legal/regulatory framework should be provided and accorded the necessary political will to enable responsive firms steer the adoption of IAS 15 by accounting professionals in their employ.

All these will enable practitioners to reengineer corporate governance and meaningfully attract the much desired competitive advantage, as conceptualized and presented in Figure 2:

**Figure 2: IAAS Compliance – Competitive Advantage Connect**



*Source: Conceptualized by Authors*

The time for foot-dragging on sensitive issues relating to global best practices, particularly in accounting and finance, should be over as the world looks up to emerging economies to take the lead for the rest of the world to trail. Reinventing overall decisional utility of financial statements is crucial to redefining the looks of firms in the books. In this lies the strategic imperativeness of IAAS in reinventing accounting practice and redefining corporate value for sustainable competitive advantage, especially in the Nigerian economy.

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