

ESTABLISHING INFLATION ACCOUNTING STANDARDS IN THE UNITED STATES: A DEVELOPMENTAL PROCESS *

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1. Introduction

This article describes the procedures by which accounting standards are established in the United States. It illustrates the application of those procedures in practice, by describing how they are being applied to develop standards for accounting for inflation.

The United States has a unique institutional structure for the promulgation of accounting standards – a private sector Financial Accounting Standards Board (referred to as “the Board” or “the FASB”) that is supported by, but independent of, government, industry, and public accountants’ organizations.

Independence and procedural safeguards are the foundations on which the FASB is built. The seven Members of the FASB serve full time and are required to sever all connections with the firms or organizations where they worked before joining the Board. The Board is assisted by a full-time staff of 45 professionals drawn from public accounting, industry, academe, and government. The Board Members are appointed and the activities of the FASB are funded by an independent Financial Accounting Foundation. The Foundation’s trustees are nominated by six sponsoring organizations whose members have special interest in financial reporting. Those sponsoring organizations represent academic accountants (professors), public accountants, investors and investment advisors (financial analysts), corporate financial executives, management accountants, and investment bankers and brokers.

So, to summarize, the sponsoring organizations nominate the trustees of the Foundation; the Foundation appoints Board Members and funds the operations of the Board; and the Board Members, with assistance of a staff, establish accounting standards. The funds are obtained by contributions from the business community and by sales of FASB publications.

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** Project Manager, Financial Accounting Standards Board. Expressions of individual views of members of the FASB and its staff are encouraged. The views expressed in this article are those of Mr. Cohen. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberation.

Procedural safeguards are assured by extensive "due process" rules. Those rules assure interested parties the opportunity to express their views to the Board and to monitor the development of projects. There are at least six formal steps in the process of setting a major standard:

(1) The FASB consults with the Financial Accounting Standards Advisory Council (FASAC) as to project priorities. FASAC, composed of 37 members, is broadly representative of preparers, auditors, and users of financial information and has been called "the Board's constituency in microcosm".

(2) A task force of technical experts, drawn from a broad spectrum of preparers, auditors, and users, is appointed to advise the Board and staff on the project as it proceeds.

(3) A comprehensive document called a Discussion Memorandum, which discusses the technical issues and possible solutions, is developed by the FASB staff with the advice of the task force. Comments on the Memorandum are received from people and organizations that are interested in the subject. Typically, about 30,000 copies of such a document are distributed and a few hundred letters of comment are received by the Board.

(4) A public hearing is held. Any person who wishes may explain his or her views to the Board Members, who then discuss those views with the person. Public hearings usually last two or three days. Between 20 and 40 organizations and individuals present their views. Each presentation, with a follow-up question-and-answer session, lasts 20 to 30 minutes.

(5) A proposed accounting standard (an Exposure Draft, or "ED") is developed by the Board and staff and issued for comment. More than 40,000 copies of an ED are distributed and comments are invited, usually within 60 to 120 days. Several hundred letters of comment are received.

(6) The Board meets periodically to discuss the rules that will be included in Exposure Drafts and final Standards. All those meetings are announced ahead of time and are open to public attendance. The decisions made at the meetings are published by the FASB in a weekly bulletin. Meetings of task forces, FASAC, and the Financial Accounting Foundation also are announced in advance and open to the public.

FASB Standards are officially recognized as authoritative by the Securities and Exchange Commission (SEC) and by the Rules of Conduct of the American Institute of CPAs. The practical effect of this recognition is that the SEC will not accept financial statements in reports filed with the Commission that are at variance with Standards of the FASB. CPAs who audit and express opinions on financial statements are required by their ethics rules to flag departures from FASB Statements in their audit opinions. Because of this official support, there is virtually 100% compliance with FASB standards.

With this background, let us examine how these procedures were applied in developing accounting standards to measure effects of inflation.

2. Development of inflation accounting standards

Financial statements and accounting principles have developed gradually over time – mostly relatively stable times. Just as an automobile built to operate on smooth highways will not work well on rough, unpaved roads, so traditional accounting based on historical costs does not communicate well during inflation. It is a machine built to operate best when prices are stable. Interest in modifying the accounting machine to make it work better during inflation has waxed and waned as the inflation rate has fluctuated. In the late 1960s, there was a recommendation that financial statements be supplemented with information adjusted for changes in the general price level. Very few companies followed that recommendation.

At the end of 1974, as inflation accelerated, the FASB issued an Exposure Draft proposing to require supplementary disclosures of specified information stated in units of general purchasing power. The following year, before the Board had completed action on this project, the SEC proposed to require certain publicly held companies to disclose replacement cost information. Shortly thereafter the FASB announced that a final Statement on purchasing power accounting would be deferred, pending analysis of a field test of its Exposure Draft. The SEC, meanwhile, proceeded with its replacement cost requirements – issued as Accounting Series Release 190 – that became effective at the end of 1976.

There the matter stood until the spring of 1978. Several forces combined at about that time to generate a new flurry of activity in inflation accounting.

(1) Harold Williams had become chairman of the SEC. He brought to that position a deep interest in inflation accounting, fueled by a strong concern that many companies were involuntarily liquidating themselves by slow degrees and that neither management nor shareholders were getting the figures that revealed the extent of the damage. John “Sandy” Burton, chief architect of the replacement cost accounting requirements, had left the staff of the SEC.

(2) The inflation rate was again rising. In 1978 the widely-reported Consumer Price Index revealed an increase in the rate of inflation for the third year in a row; inflation was about to soar into double digits. Inflation in the United States had become a major concern to more than economists and politicians: business people and consumers rated it as the most important problem facing the nation.

(3) There was widespread and continuing dissatisfaction with the SEC’s replacement cost requirements.

(4) And finally, there was renewed feeling that the inflation-accounting problem needed extended consideration and broad public participation – in short, that the FASB should take another crack at it.

The FASB initiated a project to develop disclosures about effects of changing prices early in 1978 as an offshoot of a related project on how assets

should be measured. A task force of 23 people assisted the Board as it developed proposed standards. Two related Exposure Drafts were issued: one in December 1978, the other in March 1979.

The proposed rules would have required large publicly held companies to disclose certain supplementary information about effects of inflation. Although this article will not delve deeply into the technical controversies involved, several aspects of the proposals deserve attention because their evolution illustrates how the Board listened and responded to the views of interested parties.

The most novel provision was that the proposed rules were avowedly experimental. All previous FASB standards had resolved accounting controversies by setting rules that were indefinite, if not permanent. But in these proposals the Board acknowledged that there were two general approaches to providing inflation-adjusted information and that it was not choosing between them. Companies would be allowed a virtually free choice between the methods.

Another unusual provision was a proposed limitation on the applicability of the requirements. The proposal would apply only to large publicly owned businesses; small public companies and closely held businesses would not be required to provide the information that their large brethren would. This limitation on applicability was consistent with the experimental approach to setting standards in this area. In this case, limiting the requirements to large public companies was particularly appropriate because they have the accounting skills and sophisticated records necessary to generate the information, and their annual reports are widely distributed. In a sense they are corporate America. It was estimated, accurately as it turned out, that 1,250 to 1,500 companies would have to provide the information.

The flexibility built into the proposal was also unusual but was consistent with the experimental nature of the standard. Although the relative flexibility of this standard can best be appreciated by comparison with other, less flexible FASB pronouncements, such a comparison is beyond the scope of this article.

The principal provision in the drafts that reflected the flexibility theme was the proposal that companies provide inflation-adjusted information based on either one of two general approaches. One approach is called "current cost", the other is "constant dollar".

The current cost approach substitutes the *current* prices of inventory and property, plant, and equipment in place of the *historical* costs that are used in conventional (historical cost) financial reporting. For example, assume that a machine lathe cost a company \$50,000 five years ago and is being depreciated over ten years. Under historical cost accounting, the annual depreciation charge is one-tenth of \$50,000, or \$5,000. But what if the same lathe now costs \$80,000? Under historical cost accounting the depreciation expense is still \$5,000, year after year. Under current cost accounting the depreciation expense

is raised to \$8,000. This amount, it is argued, reflects the current worth of the machine's services consumed in the current year.

The current cost adjustment to inventory is similar. If inventory that was purchased originally for \$5,000 is sold, historical cost accounting shows cost of sales of \$5,000. If the selling price is \$9,000, the apparent gross profit is \$4,000. But if the company has to pay \$6,000 to replace the inventory, it will have only \$3,000 in cash that it can distribute (\$9,000 selling price minus \$6,000 to replace the inventory). Current cost accounting shows the cost of sales as \$6,000 and the gross profit of \$3,000. The \$1,000 difference between historical cost profit of \$4,000 and current cost profit of \$3,000 is sometimes referred to as "inventory profit", that is, profit that has to be used to replace inventory and is not available as cash.

In contrast to current cost, the constant dollar approach considers inflation to be a decline in the *general* purchasing power of money, which, strictly speaking, it is. This approach assumes that although money and other monetary items (such as accounts receivable, accounts payable, and long-term debt) lose their value during inflation, non-monetary items (principally inventory and property, plant, and equipment) retain their purchasing power. That is, they "keep up with" inflation. The constant dollar approach restates inventory and property, plant, and equipment upward by the amount of general inflation during the year. For example, if a company has \$100 in cash and \$100 of land and has no transactions for three years, the unrestated financial statements will show the same \$100 cash and \$100 land at both the beginning and end of the period. But if there has been, say, 50% inflation over the three years, the constant dollar financial statements will show \$100 cash and \$150 land at the end of the three years as compared to \$100 cash and \$100 land at the beginning of the period. Graphically, it would look like the diagram shown in fig. 1. The message is simple, but dramatic: during periods of inflation, cash loses value but physical assets retain value.

The major shortcoming of this approach is obvious: neither the values nor the prices of assets such as land, inventory, machines, or buildings necessarily move at the same rate, or in the same direction, as general inflation. We all can

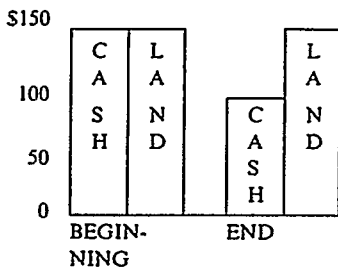


Fig. 1.

think of examples of land that has declined in value, despite inflation, or increased in value much faster than general inflation. There are serious questions about the usefulness of the \$150 figures – it might even be called the \$150 question. (It used to be called the \$64 question, but it has been increased because of inflation!)

A final aspect of the proposed rules deserves at least a brief mention: the new figures – current cost and constant dollar amounts – were to be provided as *supplementary* data. They would not replace the traditional financial statements but would be presented in addition to those statements in a footnote at the end of the annual report.

As it developed those proposals, the Board became aware that unique measurement problems might require special treatment in certain industries. Six industry task groups – consisting of busy CPAs, business executives, and financial analysts, who volunteered their time – were formed in January 1979 to identify the problems of applying the proposed general rules in the Exposure Drafts to certain assets in their industries. The industry groups studied banking (including thrift institutions), forest products, insurance, mining, oil and gas, and real estate. Working under extremely tight time pressure, all six task groups held open meetings to discuss the issues, issued preliminary reports in April 1979, held public hearings in May 1979, and submitted reports to the Board by the end of May 1979. Also in May, the Board sponsored a one-day conference – which was attended by more than 400 financial executives, analysts, practicing accountants, professors, and public sector policy-makers – to call attention to the urgency of the need for better disclosure of the effects of inflation on business. Shortly thereafter the Board held a three-day public hearing on its proposals. Letters commenting on the Exposure Draft proposals were received from 450 individuals and organizations.

A listing of events is, by itself, dry as dust, but it illustrates the themes of due process: extensive communication and wide participation.

Although the comments at the hearings and in comment letters expressed widely diverse opinions, there seemed to be a general consensus that some form of inflation accounting information should be provided. There was practically unanimous agreement that the applicability of the requirements should be limited to large publicly held companies and that the new information should supplement rather than replace the traditional historical cost-based financial statements.

But there the agreement ended and discord began. The area of greatest controversy was, ironically, the area of greatest flexibility in the proposal: the provision allowing free choice between the current cost and constant dollar approaches. Some were confused by the apparent openness of the choice. They could hardly believe their eyes and suspected that what the big print apparently gaveth, the fine print somewhere else tooketh away. Others argued that comparability of method among different companies, particularly compa-

nies in the same industry, was extremely important. From that common starting point, some proceeded to argue for current cost – it was more relevant, it reflected the company’s individual experience with changing prices, and it was more practically useful. Others argued for constant dollar – it was more objective, it could be audited and certified, and (not to be sneezed at) it was easier and cheaper to calculate. A few lonesome souls argued that information on both methods should be provided. At the other end of the spectrum, some said that the problem would soon disappear, both proposed methods were unfamiliar and untried, the old ways were the best ways, and no inflation-adjusted information was needed.

As is usual in such cases, there was some merit in all of the arguments, and the Board faced difficult decisions.

3. Major provisions of inflation accounting standard

After extended discussion at open meetings in the summer of 1979, the Board issued its rules on inflation accounting in September 1979 – eagerly awaited by some, dreaded by many, but unexpected by only a few.

It was clear that the most difficult problem would be to choose between the current cost and constant dollar methods. Like Solomon with the baby, the Board developed an unexpected solution. It was different from the Exposure Draft; it pleased very few entirely. In a way it was a non-decision, but it worked. The final rule required *both* current cost *and* constant dollar information for an experimental period.

There had been little practical experience with either current cost or constant dollar measures; and opinions were very evenly divided. It would have been difficult, and perhaps even presumptuous, to select one method and discard the other on the scant evidence available at that time. The weight of theory seemed to favor the current cost approach, but the weight of opinion, if one merely counted the number of comments, favored the constant dollar method.

The board was not unanimous in its decision: five of the seven Board members voted for the standard and two dissented. David Mosso dissented because the dual approach diffused the effects of the disclosures and because he believed the usefulness of the constant dollar approach had not been demonstrated. Mr. Walters dissented because he believed the dual approach created a confusing combination of attempts to deal with two fundamentally different issues – changes in the exchange value of money (addressed by the constant dollar adjustments) and changes in specific prices (addressed by the current cost adjustments). In contrast to Mr. Mosso, he thought that it was more important to recognize changes in the purchasing power of money and favored the constant dollar approach. He believed that the current cost

information was incomplete and difficult to understand. He shared Mr. Mosso's concern that the disclosures did not focus on one measure of income.

The Board argued, in explaining its decisions, "that both methods could be implemented with acceptable reliability" [1]. The constant dollar methodology had been field tested by 101 companies in 1975 [2], and more than 1,000 companies had prepared replacement cost information for the SEC that was similar to current cost. The Board was also concerned that if it allowed companies to choose freely between current cost and constant dollar, companies in the same industry might choose different methods and the resulting information would not be comparable. There was also the possibility that given a choice, a large majority of companies would choose the same method. In that event, there might not be enough evidence at the end of the experimental period to compare the two methods [3].

To avoid the impression that it was simply ducking a difficult decision, the Board strengthened the experimental theme by committing itself to review the requirements after a designated time. "The Board intends to assess the usefulness of the information called for by this Statement. That assessment will provide a basis for ongoing decisions on whether or not provision of both types of information should be continued and on whether other requirements in this Statement should be reviewed. The Board will undertake a comprehensive review of this Statement no later than five years after its publication" [4].

Let us now describe that review procedure.

4. Evaluation of the experiment

With an experiment as extensive and complex as this, it was important to plan the evaluation process well in advance. Planning for the evaluation began less than two years after Statement 33 was issued. The evaluation has been controlled by five general themes: early planning, extensive participation by interested parties outside the FASB, a focus on research to evaluate the existing requirements, extensive reliance on outside support to finance and perform the research, and concentration on areas of particular difficulty or controversy.

The task force that had assisted the Board in developing Statement 33 was reorganized in the spring of 1981. The reorganized group advised the Board on research that would be necessary to evaluate the existing disclosures and to resolve issues left open by Statement 33 and helped prepare an Invitation to Comment on the Need for Research on Financial Reporting and Changing Prices. That document, published in June 1981, described areas in which research might be useful. It also outlined a role for the FASB:

- (a) to monitor research undertaken by others;
- (b) to sponsor a limited amount of research;

(c) to develop a data bank of computer-accessible numerical information published under Statement 33; and

(d) to facilitate communication of research efforts and results to the Board and among outside researchers.

Reactions to that document generally supported the need for a research program, a strong coordinating role for the FASB, and a speedy reconsideration of Statement 33.

By the end of 1981, the FASB had developed nine specific areas where it believed research was necessary, such as management use of inflation-adjusted information, use of the information by financial analysts, investment advisors, and investors, and the specific techniques used to prepare current cost information. More than 100 college accounting faculties were contacted to find out what research in this area was in process and to obtain specific proposals for additional research. Representatives of several of the major private-sector organizations that are most involved in establishing accounting standards – the Financial Executives Institute, the Financial Analysts Federation, the American Institute of CPAs, several of the large CPA firms, the National Association of Accountants, and the American Accounting Association – met with the FASB staff to discuss their views and how they might participate in and support specific research projects.

As this article goes to press, over a dozen research projects have been developed and financed. Additional projects are in various stages of development. The research is being performed by public accounting firms, accounting professors, a forester, a financial analyst, and an appraisal company. Financial support has come from the accounting firms, accounting organizations, industry associations, and private companies.

A data base containing all of the numerical inflation-accounting disclosures provided by almost all of the companies subject to Statement 33 has been prepared and made available on computer tape. It has been widely used by accountants interested in determining industry patterns, aggregate statistics, trends, and other mathematical manipulations of the data.

5. Plans for the future

Much of the research will be complete, or nearly so, by the end of 1982. The FASB is planning a one-day conference that will serve as a focal point for the commissioned research. It is expected that the conferees – senior business executives, researchers, public accountants, academicians, and other members of the financial accounting community – will discuss the research reports, develop issues on which additional research is indicated, and suggest actions by the FASB to make the experiment more meaningful.

The results of the completed projects will be made available to the Board

and published shortly after the conference, perhaps with an invitation to comment on perceived needs for additional research. Existing requirements probably will be reviewed and revised in the 1983–84 time frame.

It is important to recognize that research, by itself, will not point an unwavering finger at one specific, detailed set of requirements as *the* one best answer. For example, two criteria for accounting information are that it be relevant and reliable. Research may show clearly that some accounting measures, such as current value, may be very relevant but not very reliable (different estimates of value may be far apart). Other accounting measures, such as the historical cost of a machine, may be very reliable (everyone can agree on what the number is) but of questionable relevance (what good is it to know what the machine cost many years ago?). It is obvious that different criteria lead to different accounting measures. Research will not discover or prove that relevance is more or less important than reliability; it will not make choices automatic or obvious. Rather, research will provide data and insights, perceptions and statistics that can, when used with judgment, courage, and discretion, significantly enhance the quality of accounting standards.

6. Conclusions

The FASB is accepted as the authority for accounting standards because there is a recognized need for such an authority and because of the Board's independence and its extended consultative procedures. Those procedures are designed to obtain the best thoughts of all concerned parties at each step of the process.

As the preceding discussion makes clear, many difficult and controversial technical issues remain to be resolved in the area of inflation accounting. The steps taken so far, and the additional steps that have been put in train, assure that appropriate information will be available to the Board on a timely basis, that informed constituents will be fully involved, and that relevant facts and knowledgeable opinions will be brought to bear to produce the best possible accounting standards.

Notes

- [1] FASB, Statement of Financial Accounting Standards No. 33: *Financial Reporting and Changing Prices* para. 109 (1979).
- [2] FASB, Research Report: *Field Tests of Financial Reporting in Units of General Purchasing Power* (1977).
- [3] FASB, Statement No. 33, *supra* note 1, at para. 111.
- [4] *Id.* at iii.

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