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## Analysis of Financial Statements: Current Value Versus Historical Cost

Jerry A. Topp

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ANALYSIS OF FINANCIAL STATEMENTS:  
CURRENT VALUE VERSUS HISTORICAL COST

by

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Bachelor of Science, Valley City State College 1974



An Independent Study  
Submitted to the Faculty  
of the  
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## CHAPTER I

### AN INTRODUCTION TO CURRENT VALUE ACCOUNTING

#### Introduction

Inflation has become a troublesome reality with which the world has been forced to live. The accounting profession recognizes that inflation not only determines the way people live, it also causes historical cost financial statements to report something less than reality. The possibility exists that economic decisions may be distorted by inflation's influence on historical cost financial statements.

The profits reported on historical cost statements would tend to be higher than may actually exist. If this is the case, users of such financial statements may obtain a false impression about the economic position of the entity. This may lead to excessive dividends declared, investments that may not be financially sound, demands from stockholders to pay dividends if none were declared, or even excessive tax liabilities.

Because inflation will probably continue into the future, new methods of accounting are being developed to fulfill the need for financial statements that report "economic reality." Some of the alternatives that are available will be discussed later in this chapter. For purposes of

this paper current value accounting will be defined in terms of replacement costs, as will be discussed in the following pages.

Replacement costing, as will be explained later, has been required by the Securities and Exchange Commission (SEC) to be disclosed in the financial statements of certain large corporations. The purpose of this paper is to determine the effect of such reporting on the users of such financial information. This will be accomplished by the application of ratios, used in analysis of financial statements, to comparative financial statements of selected corporations. These ratios will provide information from both current value statements and historical cost statements. This information will be compared and analyzed to determine whether current values will have a material influence on the users of such information. The results of these tests will be the basis of opinions that will only be applicable to those statements presented within the scope of this paper, in light of the limited number of comparative statements available.

In addition to the mechanics of this paper, a brief review of current value will be presented to enable the reader to recall the many options that are available for current value accounting. A portion of this paper will include the history of current value accounting, as well as, the arguments for and the arguments against. This information is presented in order that the reader will have a

basic understanding of current value accounting when evaluating the conclusions drawn in the final chapter.

### Current Value Accounting

Current values, in some respects, are related to price level accounting. For example, it draws the same distinction between monetary and nonmonetary items. On the other hand, a major difference is that it substitutes fair or current dollar values for the general index restatement of nonmonetary items.<sup>1</sup>

The following list consists of several methods proposed to measure current values and brief definitions to explain each.

#### Entry Values:

1. Replacement Cost
2. Reproduction Cost

#### Exit Values:

3. Realization Value

#### Special:

4. Discounted Cash Inflows
5. Specific Price-Index Numbers
6. Appraisals

Replacement cost is the estimated cost of acquiring new similar items at current prices after allowing for comparable physical and functional depreciation that has already occurred on the items being valued. If property would serve the same function, it need not be identical.

Reproduction cost is the estimated cost of producing new essentially identical property in kind adjusted for physical and functional depreciation to date.

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<sup>1</sup>Glenn A. Welsch, Charles T. Zlatkovich, and John Arch White, Intermediate Accounting (Homewood, Ill.: Richard D. Irwin, Inc., 1976), p. 1088.



Realization value is the amount that could be realized from the current sale of the item assuming no forced or distress sale is implied. It is recognized that many of the assets of an entity are not ordinarily up for sale.

Discounted cash inflows are the present value of the future estimated net cash inflows, or cost savings, of an item being valued. The future cash inflows are discounted at a realistic rate of interest.

Specific price-index numbers are regularly developed and published for various types of construction, kinds of machinery, equipment, and vehicles, and for hundreds of commodity groups. Some larger companies have found it feasible to develop their own index numbers to value specific assets, such as plant assets. Specific index numbers are to be distinguished from general index numbers such as the GNP Deflator which measures changes in a broad range of prices. Whereas, general index numbers can be used to measure changes in general purchasing power, specific index numbers tend to measure the change in value of single or groups of similar items. Thus, specific index numbers are often viewed as a realistic way to measure fair value.

Appraisals are estimates developed by professionally competent and independent individuals of the current fair value of an item in its present condition.<sup>2</sup>

From the above list all methods fall into three categories: (1) The present value of discounted cash flows, (2) current realizable value, and (3) replacement cost.<sup>3</sup> Some accountants believe that present value would be the ideal method for obtaining economic reality. Present value, even though the ideal method, will probably not become an accepted method. Determining the cash flow from a massive range of assets would be next to impossible and would certainly be criticized for subjective estimates of cash flows. Some people concede that the implementation difficulties in

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<sup>2</sup>Ibid., p. 68.

<sup>3</sup>Ernst & Ernst, Accounting Under Inflationary Conditions (New York: Ernst & Ernst, 1976), p. 18.

applying discounted cash flow concepts of value and net income to the operating assets of many companies on a realistic basis are overwhelming.<sup>4</sup> The current realizable value method falls to much of the same criticism as present values. Questions are raised as: Does one plan on selling assets piece by piece or as a whole? Does one assume a forced sale liquidation or disposition on a going concern basis? What value is to be used if no sales of plants of this kind or size have taken place recently?<sup>5</sup> These types of questions have caused the current realizable value method to receive less than mild support.

The remaining method, replacement costs, will be used throughout this paper in reference to current value accounting. This method received strong support by the SEC. The SEC in Accounting Series Release No. 190 (ASR 190) required replacement costs to be disclosed for certain large corporations.<sup>6</sup> This will be discussed at greater length in Chapter Two.

#### Replacement Costs

Replacement costing is considered by some to most closely estimate discounted cash flows.<sup>7</sup> The problem with

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<sup>4</sup>Ibid., p. 19.

<sup>5</sup>Ibid., p. 20.

<sup>6</sup>Accounting Series Release No. 190, Securities and Exchange Commission, Washington, D. C., U. S. Government Printing Office, March 23, 1976.

<sup>7</sup>Ernst & Ernst, Accounting Under Inflationary Conditions, p. 21.

replacement costs is that there is more than one option when considering cost of replacing an asset. These options consist of: (1) Reproduction cost of existing assets, (2) Replacement cost of existing assets, or (3) Replacement cost of existing capacity.<sup>8</sup> A brief definition of these terms are as follows.

Reproduction cost of existing assets. The cost to replace a single asset without considering technological improvements. Reproduction cost is frequently approximated through price level adjustment of historical cost amounts using specific price indexes.

Replacement cost of existing assets. The cost to replace a single asset or groupings of congruous assets with other assets of equivalent productive capability. Replacement cost is equivalent to reproduction cost only in those relatively rare instances when there has been no technological change.

Replacement cost of existing capacity. The cost to replace productive capacity without regard to existing assets or their physical distribution. This approach represents a forecast of how the company might proceed if it were to establish a competing business with identical productive capacity. For this purpose, technological change, economics of scale, and other anticipated savings are all considered.

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<sup>8</sup>Ibid., p. 22.



Variations in the way these influence replacement cost seem unavoidable.<sup>9</sup>

From these methods a variation of replacement cost was defined by the SEC as:

. . . the lowest amount that would have to be paid in the normal course of business to obtain a new asset of equivalent operating or productive capability. In the case of depreciable, depletable or amortizable assets, replacement cost (new) and depreciated replacement cost should be distinguished. Replacement cost (new) is the total estimated current cost of replacing total productive capacity at the end of the year while depreciated replacement cost is the replacement cost (new) adjusted for the already expired service potential of such assets.<sup>10</sup>

Since this is the definition most companies will live with in their attempt to comply with ASR 190, it would seem logical that it should also be the definition of replacement costs in this paper.

An objective of replacement cost accounting is to show what inflation has done to the earning power of the company. Historical cost accounting shows how many dollars a company did in fact make in a given period. But to determine how much of that sum can be paid in dividends, management needs to know what it will cost to replace the assets that are being used up. To form an opinion of a stock, some investors would like to know what will happen to the

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<sup>9</sup>Ibid., p. 22.

<sup>10</sup>"Haskins & Sells Issues Guide on SEC Replacement Cost Compliance," Journal of Accountancy 142 (December 1976): 22.

company's earning power as an old plant wears out and is replaced by new equipment bought at current prices.<sup>11</sup>

#### SEC Requirement

As stated, ASR 190 has given important official support to replacement costs. The impact of ASR 190 will be hard to determine until more research is completed and more practical experience results from the disclosure required by the SEC. What ASR 190 requires is that corporations whose fiscal year ends on or after December 25, 1976, and which have inventories and gross property, plant and equipment totaling more than ten (10) million dollars and ten percent (10%) of total assets, are responsible for disclosing quantified replacement cost information in their 10-K reports, which are filed with the SEC. Also, the firm must provide a general discussion of the effects of replacement cost data in its annual report. The replacement cost disclosure required by the SEC include:

1. Replacement cost of inventories.
2. Replacement cost of the productive capacity.
3. Depreciated replacement cost of the productive capacity.
4. Cost of sales using the replacement cost of the inventory at the time of sale.

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<sup>11</sup>"Replacement Cost: Clarification or Confusion?"  
Business Week, August 9, 1976, p. 54.

5. Depreciation based on the average replacement cost of productive capacity.<sup>12</sup>

Because replacement accounting is still experimental, the SEC is not asking companies to compute a new net income figure based on replacement costs. They need only disclose the replacement cost of inventories and fixed assets and then calculate the effects of depreciation and the cost of goods sold. Reported earnings will be based on historical cost accounting, but investors and security analysts can use the new figures to come up with their own adjustments to corporate profits.<sup>13</sup>

A general result of using this method of reporting is that it results in a lower net income.<sup>14</sup> This is a result of restating depreciation and cost of goods sold at a higher amount than would be reported on historical cost statements. One disturbing problem with this result (more will be discussed in a later chapter) is that the Internal Revenue Service does not accept current value accounting as a basis for tax.<sup>15</sup> This will cause some to be skeptical about reporting lower earnings to investors with no benefit from the IRS.

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<sup>12</sup>James McManus, "Replacement Cost Disclosure: An SEC-Imposed Experiment," The National Public Accountant 22 (September 1977):35.

<sup>13</sup>Business Week, "Replacement Cost: Clarification or Confusion?", p. 54.

<sup>14</sup>Ibid.

<sup>15</sup>Ibid.



Developing the Information

The responsibility for developing the replacement cost information has been placed on the accountant. His job is to closely determine the replacement cost of certain assets by the use of some method. At best, the replacement cost information will be estimates and subjective to the experience and conservative nature of individual accountants.

Three methods of developing replacement cost data have been suggested as solutions to the accountant's dilemma: (1) Indexing, (2) Functional pricing, and (3) Direct pricing.<sup>16</sup>

Of these three methods the easiest to implement would be indexing. Under this method price indexes that apply to specific assets can be applied to historical cost information and the result is an approximation of replacement values. There are many indexes available to provide such information. The wholesale price index published monthly by the Bureau of Labor Statistics is a composite of 2,700 indexes.<sup>17</sup> This method, although the easiest to apply, may result in the most misleading information. Specific indexes do not take into account changes in technology. Certain items, such as calculators, have changed at a rate opposite inflation due to advanced technology. In testing four separate cost indexes, Shell Oil Co. found that they produced replacement cost that were more than 25% apart.<sup>18</sup>

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<sup>16</sup>Ibid., p. 55.

<sup>17</sup>Ibid.

<sup>18</sup>Ibid.

Functional pricing is a more accurate tool for large production components, but is more difficult to use. The basis of this method is the determination of productive capacity. This would measure many assets in terms of productive output. One way to determine unit-of-production measure is to start with the cost of a company's newest constructed plant and update that with an index of construction costs. This figure could then be applied to the old plant's present productive capacity. Such an approach also takes into account the impact of technological change.<sup>19</sup> The problem exists when a company's newest plant may be 25 years old. In this case it may be necessary to rely on engineer's estimates on latest plant designs.

The last option currently used is direct pricing. This method merely obtains current costs by means of quotes from suppliers and catalogues. It is best suited for large standard pieces of equipment for which market prices are readily available. Smaller firms may decide to use outside appraisal or valuation companies to obtain replacement cost data.<sup>20</sup>

From the previous definitions and discussions of replacement costs, it becomes evident that no one system or method is superior at the present time. The one thing that is certain to occur is that depreciation charges will

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<sup>19</sup>Ibid.

<sup>20</sup>Ibid.

increase dramatically and net income will be lower. The oil industry may be the most seriously "hit" by the SEC's requirements in that they will be forced to determine a replacement cost for oil and gas reserves. Robert O. Anderson, chairman of Atlantic Richfield Co. said, "I fear the industry (oil) will see red rather than black ink."<sup>21</sup>

Because companies are allowed to experiment with different methods of costing, it will be difficult to obtain information that is comparable even within the same industries. The question remains: Just how "realistic" will these new figures be? Is it possible for accountants to "concoct" a figure that is closer to "reality" than historical costs?<sup>22</sup>

Because of these reasons and remaining questions it must be pointed out again that any conclusions reached in this paper apply only to the financial statements from which the information for such conclusions were drawn. Thus the stage is set for accountants to debate and experiment with replacement cost accounting to fulfill the SEC's imposed desire.

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<sup>21</sup>Ibid.

<sup>22</sup>Ibid.

<sup>1</sup>Robert O. Anderson and Philip H. Ball, *Theory and Measurement of Business Income* (Berkeley: University of California Press, 1941).

<sup>2</sup>"Statement of the Accounting Principles Board No. 3: Financial Statements Restated for General Price Level Changes," *Journal of Accountancy* 124 (September 1942): 13.



## CHAPTER II

### HISTORY OF CURRENT VALUE ACCOUNTING

When did inflation begin? If the exact date inflation started was known, then it would be safe to say that it was also the day someone questioned the validity of historical cost financial statements.

The first major publication to become a basis for later proposals is a book by Edwards and Bell. It was not realized until later the significance the book had; it was reprinted in 1961.<sup>1</sup> The reason that this book found new life is that recent double digit inflation has touched off a new round of debate on how to keep up with inflation in financial reporting.

In response to the demands for a solution to the problem of accounting for changes in inflation, the Accounting Principles Board (APB) issued Statement No. 3.<sup>2</sup> This statement suggested the use of general price-level accounting and that the GNP Implicit Deflator be used as the most comprehensive index for determining changes in the rate of inflation.

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<sup>1</sup>Edgar O. Edwards and Philip W. Bell, Theory and Measurement of Business Income (Berkeley: University of California Press, 1961).

<sup>2</sup>"Statement of the Accounting Principles Board No. 3: Financial Statements Restated for General Price Level Changes," Journal of Accountancy 128 (September 1969):63.

During 1971, the American Institute of CPAs established a study group to make recommendations for improving the process of establishing accounting principles.<sup>3</sup> This committee was later named the Trueblood Committee in honor of the late Robert M. Trueblood, chairman, partner of Touche Ross & Co.<sup>4</sup> This point may be significant, because Touche Ross & Co. has been one of the leading advocates of current value accounting.<sup>5</sup> It should also be noted that of the three companies used in preparation of this paper, two of those companies are serviced by Touche Ross & Co.

The Trueblood Committee established a number of objectives of financial reporting. There are two that seem to point in the direction of some form of current value accounting:

Objective No. 6--An objective of financial statements is to provide factual and interpretive information about transactions and other events which is useful for predicting, comparing and evaluating enterprise earning power. Basic underlying assumptions with respect to matters of interpretation, evaluation, prediction, or estimation should be disclosed.

Objective No. 7--An objective is to provide a statement of financial position useful for predicting, comparing and evaluating enterprise earning power. This statement should provide information concerning enterprise transactions and other events that are part of incomplete earnings cycles. Current values should also be reported

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<sup>3</sup>Kenneth S. Most and Arthur Lee Winters, "Focus on Standard Setting: From Trueblood to the FASB," Journal of Accountancy 143 (February 1977):68.

<sup>4</sup>Ibid.

<sup>5</sup>Touche Ross & Co., Current Value Accounting--Economic Reality in Financial Reporting (New York: Touche Ross & Co., 1976).

when they differ significantly from historical cost. Assets and liabilities should be grouped or segregated by the relative uncertainty of the amount and timing of prospective realization or liquidation.<sup>6</sup>

These objectives, which indicate a move in the direction of current values, may have added enough fuel to the flame to cause the SEC to issue ASR No. 151. This recommended that when significant differences exist between historical and replacement cost of goods sold, additional disclosure is needed to inform the investing public that the reported profits may be inflated because older costs are matched against current revenue figures.<sup>7</sup>

With the departure of the APB, the Financial Accounting Standards Board (FASB) inherited the problem. The FASB did not have an inflation proposal on their agenda, until in 1974 the dramatic increase in inflation caused them to act.<sup>8</sup> The Board issued an exposure draft on December 31, 1974, entitled "Statement on Financial Reporting in Units of General Purchasing Power."<sup>9</sup> After a long delay, the Board announced in November that a final statement would not be issued in 1975. The FASB wanted more time to complete and

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<sup>6</sup>Accounting Objectives Study Group, Objectives of Financial Statements (New York: AICPA, 1973).

<sup>7</sup>Accounting Series Release No. 151, Securities and Exchange Commission, Washington, D. C., U. S. Government Printing Office, January 3, 1974.

<sup>8</sup>"FASB Adds Price Level Project to Agenda," Journal of Accountancy 137 (March 1974):12.

<sup>9</sup>"Inflation Accounting Proposal Deferred: SEC's ASR No. 190 Cited," Journal of Accountancy 142 (July 1976):14.



analyze field tests it was conducting on general purchasing power.<sup>10</sup>

On March 23, 1976, the SEC issued ASR 190, which required certain current replacement costs to be disclosed in the financial statements.<sup>11</sup> This finalized the reporting requirement. "The staff of the SEC acknowledged that the requirement was an experiment aimed at developing techniques which did not presently exist."<sup>12</sup>

In June 1976, the FASB decided to defer any consideration of the exposure draft issued in 1974. The data required by ASR 190 was cited as an important factor.<sup>13</sup> The FASB made it clear that they would not jump on the bandwagon immediately. Robert T. Sprouse, Vice-Chairman of the FASB stated:

The FASB, with the help of 84 corporations, conducted extensive field tests in connection with the exposure draft on Financial Reporting in Units of General Purchasing Power. Those field tests were costly and time-consuming for both the FASB and the participating companies. It should be emphasized that while this field test procedure has been costly and time-consuming, the board believes it is necessary to follow such deliberate procedures in connection with projects with such broad ramifications. The board would propose to follow similar deliberate procedures in its consideration of the current value question.<sup>14</sup>

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<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> Donald A. Corbin, "SEC Replacement Costs: Suggestions for Full Disclosure," Management Accounting 59 (August 1977):12.

<sup>13</sup> "Inflation Accounting Proposal Deferred: SEC's ASR No. 190 Cited," p. 14.

<sup>14</sup> Robert T. Sprouse, "Understanding Inflation Accounting," CPA Journal 47 (January 1977):26.

Staff Accounting Bulletin (SAB) 7, was issued concurrently with ASR 190. It defined some of the terms and answered some of the questions raised in response to the SEC's original proposal. SAB's 9 and 10 were issued later and provided additional interpretations.<sup>15</sup>

Public reaction to the SEC's action was mixed. The Rouse Company, which will be examined in this paper, welcomed the chance to report current costs.<sup>16</sup> But at least 279 companies did not share their enthusiasm.<sup>17</sup> A survey, conducted by the National Association of Accountants, of the chief financial executives of the country's 1,000 largest corporations (28% responded) showed the officers thought the rule would prove costly to implement, mislead investors and further aggravate the equity market.

The Commission admitted that it was requiring companies to make disclosures of costs which cannot be calculated with precision. Nevertheless, the Commission believes: "such data, even though imprecise, are important and useful to investors and that the benefits to investors outweigh the costs of preparation."<sup>18</sup>

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<sup>15</sup>Corbin, "SEC Replacement Costs: Suggestions for Full Disclosure," p. 13.

<sup>16</sup>"Rouse Pioneers More Realistic Numbers," Business Week, October 11, 1976, p. 125.

<sup>17</sup>"Corporations Doubt Usefulness of SEC Replacement Cost Data," Journal of Accountancy 142 (September 1976):8.

<sup>18</sup>Corbin, "SEC Replacement Costs: Suggestions for Full Disclosure," p. 13.

The Commission issued ASR 203 establishing a "Safe Harbor" rule to ease the concern over the imposition of liability. The rule states that in order to establish a violation of the antifraud provisions of the securities laws, one must demonstrate that the data was either prepared (1) without reasonable basis or (2) disclosed in other than good faith.<sup>19</sup> The Commission says it is adopting the rule because of the imprecise nature of replacement cost information and its desire to encourage the development and disclosure of such information in good faith. The Commission will consider the desirability of amending or eliminating the rule in light of experience. Thus a review of pertinent data was scheduled for July 1, 1978.<sup>20</sup>

Not all of the demand for current costs came from the SEC. As early as 1962, Robert T. Sprouse and Maurice Moonity in Accounting Research Study No. 3 took the following position:

In external reports, plant and equipment should be restated in terms of current replacement costs whenever some significant event occurs, such as a reorganization of the business entity or its merger with another entity or when it becomes a subsidiary of a parent company. Even in the absence of a significant event, the accounts should be restated at periodic intervals, perhaps every five years. The development of satisfactory indexes of construction costs and of machinery and equipment prices would assist materially in making the calculations of replacement costs feasible, practical, and objective.<sup>21</sup>

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<sup>19</sup>"ASR No. 203 Sets "Safe Harbor" Rule for Replacement Cost Data," Journal of Accountancy 143 (February 1977): 10.

<sup>20</sup>Ibid., p. 12.

<sup>21</sup>Harry Simons and Jay M. Smith, Intermediate Accounting (Cincinnati: South-Western Publishing Co., 1972), p. 528.



An American Accounting Association (AAA) Committee in 1964, issued Supplementary Statement No. 1. The Committee concluded that:

. . . current cost be adopted immediately as the basis of valuation for land, buildings, and equipment whenever the amounts involved are significant and the available measures of current cost are sufficiently objective.<sup>22</sup>

In 1966, another committee of the AAA issued A Statement of Basic Accounting Theory and reached this conclusion:

We recommend that current costs be reported. There are many approaches to "current values," and we suggest that the approach that is most likely to meet the standards of accounting information . . . is current cost to replace the assets or services involved.<sup>23</sup>

The question of current value accounting has drawn supporters on each side and has divided the accounting profession. To be able to form a logical opinion, a look at the views held by each faction should now be reviewed.

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<sup>22</sup>Ibid.

<sup>23</sup>Ibid.

### CHAPTER III

#### PROBLEMS ASSOCIATED WITH CURRENT VALUE ACCOUNTING

Since the topic of current value accounting generates strong feelings on each side of the issue, an examination of arguments in support (and against) current value accounting will be conducted. The views presented in this chapter are not intended to prejudice the reader, but are presented so that the reader may be aware of the problems to look for in the remaining portions of this paper.

##### Arguments in Favor of Current Values

Touche Ross & Co., as stated earlier, has been a leading advocate of current value accounting. They have stated that the effects of inflation clearly demonstrate inadequacies of conventional historical-cost basis financial statements. In years of "moderate" inflation, the deficiencies in historical cost statements were accepted simply because no one could justify the effort required to develop a better alternative.<sup>1</sup> Touche Ross & Co. have also prepared a list of distortions caused by conventional financial statements. The following

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<sup>1</sup>Touche Ross & Co., Current Value Accounting--  
Economic Reality in Financial Reporting, p. 4.

points according to Touche Ross & Co. indicate weaknesses of historical cost statements:

1. Income taxes are based on reported profits. But in periods of inflation, reported profits generally exceed economic earnings and this means the corporate income tax is a levy on economic earnings and on capital.
2. High reported earnings may cause stockholders to expect higher cash dividends. Under such stockholder pressure, corporations may follow dividend policies which result in distributions from capital rather than real earnings.
3. High reported earnings may encourage unions to bargain for wage increases and other benefits that solvency will not allow.
4. High reported earnings may even lead government agencies to requirements that both business and society can ill afford.
5. The general public may doubt the credibility of private enterprise that reports record earnings and at the same time pleads a liquidity crisis and capital shortage.<sup>2</sup>

In a very real sense, a firm's value is contingent upon its continued capability to produce through the replacement of its worn assets. In an inflationary economy, the use of historical costs tend to distort expenses downward and income upward. To this extent, the disclosure of replacement costs offer a more relevant presentation of the cost of operations and may have an impact on future financial decisions.<sup>3</sup>

Replacement cost accounting may lead to a more balanced governmental perspective toward business profits.

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<sup>2</sup>Ibid.

<sup>3</sup>McManus, "Replacement Cost Disclosure: An SEC-Imposed Experiment," p. 36.

In an age of rising demand for tax reform, a benefit could result if high corporate profits were shown to be only part reality and part illusion. In analyzing the 1975 performance of U. S. Steel Company, using replacement cost estimates, one writer has estimated that the company's effective tax rate would increase from an actual 34 percent to a projected 99 percent if replacement cost data were used for its tax return. Faced with this type of situation, Congress may be less inclined to enact legislation that would further restrict profits.<sup>4</sup>

W. G. Bremser, assistant professor of accounting at Villanova University, stated:

. . . accountants are already familiar with the statistical methods necessary to compute current replacement cost data. Since the purchase method of accounting for business combinations necessitates recording the acquired assets at fair values, some firms have obtained experience in working with current replacement cost data for plant assets. Accordingly, many auditing firms are now knowledgeable in the state of the art, and appraisal companies have aided firms in estimating replacement costs with a great deal of confidence. Since estimates of current replacement costs have proven to be adequate for these reasons, the known methods should be adequate for the proposed reporting requirements.<sup>5</sup>

The Rouse Co., a Maryland based real estate developer, became the first U. S. company to issue a balance sheet in which current values are set out along side of historical cost figures. James W. Rouse, chairman, stated, "The shareholder will have a much more dependable image of our business

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<sup>4</sup>Ibid.

<sup>5</sup>Wayne G. Bremser, "Reporting on Current Replacement Costs," Management Accounting 59 (July 1977):34.



in language he can understand--arithmetic. It says we are worth \$10 a share, yet we're selling at less than \$5. It was not fair not having some way to communicate that. Now we do."<sup>6</sup>

It is highly possible that many companies do use current values in their economic decisions. It appears that there are many who think outsiders should also have that type of information to base their decisions upon. Currently, investors seem to be relying on the statement of changes in financial position for doing this.<sup>7</sup>

To recap the arguments in favor of current values the following is presented:

1. Readers of financial statements desire to compare the results of one company with that of another. Companies have widely varying mixes of assets acquired at different times, thus the cost bases differ between companies to the extent that it is difficult, if not impossible, for a reader to evaluate how effectively one company is using its assets as compared with another company or the industry.
2. Readers of financial statements have various decisions to make which require forecasting ability. Present investors decide whether to buy more shares or sell what they have. Failure to report current values may mislead the investor and he may make decisions under the circumstances that would not be in his best interests.
3. Depreciable assets must ultimately be replaced. Although depreciation is not intended to provide a replacement fund for retired assets, the property items used up must be replaced if the entity is to continue in operation at its same level. If the

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<sup>6</sup>Business Week, "Rouse Pioneers More Realistic Numbers," p. 124.

<sup>7</sup>Bremser, "Reporting on Current Replacement Costs," p. 34.

replacement cost of these assets has risen, the excess must be raised either by additional capital or by retention of a part of net income. Since replacement must be made at current costs, proper matching requires charges based on current values.<sup>8</sup>

#### Arguments Against Current Values

In the previous discussion it was noted that one "Big Eight" CPA firm advocated current value accounting. On the opposite side of the fence awaits another "Big Eight" firm. Ernst and Ernst (E & E) does not share Touche Ross's dream of a current value world. In a recent publication Ernst has stated that the difficulty with replacement cost arises when the nature and circumstances of the asset to be replaced is considered. A simple staple like a ten-pound bag of sugar will likely be replaced by a ten-pound bag of sugar so similar that telling them apart might be nearly impossible. But a complex piece of machinery presents a different problem. It might be replaced by a greatly improved machine, or by a substantially different machine, or by equipment that produces a different product.<sup>9</sup> The lack of an adequate and accepted technology to develop replacement cost data, absence of a reasonably identifiable set of standards to reduce subjectivity to a satisfactory minimum, and a widespread failure to understand either the purpose or limitations of replacement cost data represent important deficiencies. E & E has stated, "We believe that adoption of replacement cost for financial

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<sup>8</sup>Simons and Smith, Intermediate Accounting, p. 529.

<sup>9</sup>Ernst & Ernst, Accounting Under Inflationary Conditions, p. 21.

statement purposes would introduce problems of measurement and interpretation that would far exceed those now faced in conventional financial reporting."<sup>10</sup>

In reporting net income, current value models exhibit differences similar to those found in their valuation methods. Most models try to subdivide the present net income figure into operating income, realized value changes, and unrealized value changes. As a practical matter, holding and operations are often inseparable. Manufacturing and sales operations cannot be conducted without holding inventories and other assets for a period of time, and to report these activities as if they were separable may be misleading.<sup>11</sup>

One point that seems to have a great deal of validity is that if historical costs are disposed of, a great deal of work and the discipline now incorporated in conventional accounting will be sacrificed.<sup>12</sup>

Donald A. Corbin is concerned with the fact that the disclosure required by the SEC is not complete; it is likely to be confusing or misleading, especially if used to calculate (and understate) profits; and it will not be useful. The disclosure of replacement costs alone reveals only one important aspect of changing prices. It is likely to be misleading if used to increase expenses without also taking into account holding gains on nonmonetary assets and possible gains on net

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<sup>10</sup>Ibid., p. 22.

<sup>11</sup>Ibid., p. 26.

<sup>12</sup>Ibid.



debt. Usefulness under these circumstances is open to serious question.<sup>13</sup>

In the financial statements of the Loews Corporation, the footnote disclosure included the following: "Management is of the opinion that this information is theoretical and, therefore, not meaningful in evaluating the Company's operations."

In Chapter Two, reference was made to an AAA survey of 1,000 financial executives. The majority of these executives had serious doubt as to the usefulness of current values. They estimated the extra auditing expense to run from \$10,000 to \$200,000. Nineteen percent of those responding suffered a reporting loss between 50 and 100 percent on earnings. J. G. Stoneburner, controller of the Firestone Tire & Rubber Company said, "We don't agree with the SEC that footnote disclosure of replacement cost data will make it possible for investors to obtain a better understanding of the business which cannot be obtained from historical cost financial statements taken alone, . . ."<sup>14</sup>

The most overriding corporate concern about ASR 190 relates to the lower net income figure which will result with the use of replacement cost depreciation. The projected ramifications of this include: possible stockholder dissatisfaction with lower dividends, competitive gains by companies

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<sup>13</sup>Corbin, "SEC Replacement Costs: Suggestions for Full Disclosure," p. 14.

<sup>14</sup>"Corporations Doubt Usefulness of SEC Replacement Cost Data," pp. 8, 10.



not immediately affected by ASR 190, decreasing stock values, and an increase in the cost of debt. Contributing to the confusion will be the varied techniques that will be used for determining replacement costs.<sup>15</sup>

The following list taken from a current accounting text is comprehensive and summarizes the arguments against current value accounting:

1. There are many ways of measuring current values. This leads to a lack of objective measurement and the introduction of a wide variety of values that require differing interpretations.
2. Cost is highly objective and subject to little disagreement. Thus, it is highly verifiable. Market is subjective and thus open to disagreement.
3. The purpose of depreciation is to match cost that is expended against the revenue that is produced. No adjustment of cost is necessary to achieve this purpose.
4. Value changes occur continuously. Many difficulties would be encountered in making frequent adjustments to the assets and accumulated depreciation accounts.
5. Replacement of fully depreciated properties is a separate issue from determination of net income. Technological change makes exact replacement unlikely, and each replacement is a new decision based upon expectation of future revenues.<sup>16</sup>

#### Analysis of Arguments

From the above discussion it can be said that no apparent solution to these problems is at hand. The most distressing point about current value accounting to its opponents is the lack of any objective means to measure

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<sup>15</sup>McManus, "Replacement Cost Disclosure: An SEC-Imposed Experiment," p. 36.

<sup>16</sup>Simons and Smith, Intermediate Accounting, p. 529.

current values. On the other side, the most important point noted by the advocates is the distorted earnings picture that is presented to the investors with historical cost statements. These points must be evaluated and weighed before a decision is made as to which best discloses economic reality.

The answer to the question "How are they used?" is that the answer is that sometimes people who prepare the financial statements. It must be recognized that the purpose of financial statements is to provide useful information to the users of the statements. Therefore, the information included in financial statements should be of such a nature that the users can properly interpret what the accountant is trying to convey. Hopefully, what the accountant is trying to present is the realistic financial position of the entity in which he is reporting.

In evaluating the information presented on the financial statements, the user may apply analytic procedures to help him understand the relationships involved. These procedures give results that can be compared to general "rules of thumb" or they can be compared to other entities in a similar industry. Such procedures will be used to obtain information from the statements presented.

The SEC, as stated earlier, requires that replacement costs be included in their Form 10-K filings with the Commission. Because the SEC requires only footnote disclosure on financial statements, many companies do not include detailed

## CHAPTER IV

### ANALYSIS OF CURRENT VALUE STATEMENTS

What are financial statements? How are they used? The answer to these questions sometimes escapes those who prepare the financial statements. It must be remembered that the purpose of financial statements is to provide useful information to the users of these statements. Therefore, the information included in financial statements should be of such a nature that the users may easily interpret what the accountant is trying to convey. Hopefully, what the accountant is trying to present is the realistic financial position of the entity on which he is reporting.

In evaluating the information presented on the financial statements, the user may apply analytic procedures to help him understand the relationships involved. These procedures give results that can be compared to general "rules of thumb" or they can be compared to other entities in a similar industry. Such procedures will be used to obtain information from the statements presented.

The SEC, as stated earlier, requires that replacement costs be included in their Form 10-K filings with the Commission. Because the SEC requires only footnote disclosure on financial statements, many companies do not include detailed

information in their reports to stockholders. Because this problem exists the number of financial statements available for this study was limited.<sup>1</sup>

### Analytical Procedures

The process of analyzing financial statements covers a wide range of procedures. Since most of these methods rely heavily on the subjective opinions of the users, the procedures used here will consist of those techniques which involve proportionate (or ratio) analysis.

Proportionate analysis is a system of comparing different amounts on the financial statements to obtain a ratio of that relationship. Such numbers can result in a better understanding of what is actually presented in the financial statements. This method of analysis can be broken down into three major areas: (1) Measurement of current position, (2) Measurement of equity position, and (3) Measurement of operating results.<sup>2</sup> The individual ratios that make up each of these general areas will be kept separated in applying them to the financial information. Only selected ratios will be used in the analysis of the following information.

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<sup>1</sup>To conserve space, only segments of the financial statements will be presented. The entire reproduction of the financial statements may be found in Appendix A in this paper.

<sup>2</sup>Welsch, Zlatkovich, and White, Intermediate Accounting, p. 1024.



Ratios That Measure Current Position

Ratios of current position relate to selected elements of working capital and are designed to help evaluate the short-term liquidity and the ability of the business to meet its maturing current liabilities.<sup>3</sup> The following exhibit, and those that will follow, have been taken from three corporations that have reported replacement costs to their shareholders in the form of restated financial information. These three companies are: (1) Iowa Beef Processors, Inc., (2) The Rouse Company, and (3) Barber-Ellis of Canada, Limited.

EXHIBIT 1

Current Position Financial Information

IOWA BEEF PROCESSORS, INC.

(Amounts in Thousands)	1976 Hist. Cost	1976 Current Value	1977 Hist. Cost	1977 Current Value
CURRENT ASSETS:				
Cash	\$ 11,582	\$ 11,582	\$ 15,549	\$ 15,549
Accounts Receivable	89,019	89,019	98,513	98,513
Inventories	38,199	38,199	32,239	32,239
Deferred Tax Benefit	2,139	--	1,578	--
Prepaid Expenses	533	533	1,182	1,182
TOTAL CURRENT ASSETS	<u>141,472</u>	<u>139,333</u>	<u>149,061</u>	<u>147,483</u>
CURRENT LIABILITIES:				
Notes Payable	--	--	4,000	4,000
Accounts Payable and Accrued Liab.	33,131	30,992	33,699	32,121
Federal & State Taxes	16,514	16,514	1,805	1,805
Current Portion of Long-term Debt	<u>2,325</u>	<u>2,325</u>	<u>2,019</u>	<u>2,019</u>
TOTAL CURRENT LIAB.	<u>51,970</u>	<u>49,831</u>	<u>41,523</u>	<u>39,945</u>

<sup>3</sup>Ibid., p. 1025.

## Exhibit 1 (cont.)

## THE ROUSE COMPANY

(Amounts in Thousands)	1976 <u>Historical</u>	1976 <u>Current Value</u>
CURRENT ASSETS:		
Cash and Temporary Invest.	\$ 3,805	\$ 3,805
Accounts and Notes Receivable	10,058	10,058
Other Assets, Primarily Prepaid Expenses and Deposits	<u>7,364</u>	<u>7,364</u>
TOTAL CURRENT ASSETS	<u>21,227</u>	<u>21,227</u>
CURRENT LIABILITIES:		
Accounts Payable and Accrued Expenses	<u>15,887</u>	<u>15,887</u>
TOTAL CURRENT LIAB.	<u>15,877</u>	<u>15,877</u>

## BARBER-ELLIS OF CANADA, LIMITED

(Amounts in Thousands)	1974 <u>Historical</u>	1974 <u>Current Value</u>
CURRENT ASSETS:		
Cash	\$ 30	\$ 30
Accounts Receivable	12,075	12,075
Inventories	10,118	10,367
Prepaid Expenses	<u>250</u>	<u>250</u>
TOTAL CURRENT ASSETS	<u>22,473</u>	<u>22,722</u>
CURRENT LIABILITIES:		
Bank Indebtedness	\$ 7,574	\$ 7,574
Accounts Payable	4,109	4,109
Income Taxes	1,297	1,297
Dividends-Preference	1	1
Current Portion of Long-Term Debt	<u>487</u>	<u>487</u>
TOTAL CURRENT LIAB.	<u>13,468</u>	<u>13,468</u>

SOURCE: Annual reports to shareholders for Iowa Beef Processors, Inc., The Rouse Company and Subsidiaries, and Barber-Ellis of Canada, Limited.

Since current value accounting breaks items down into monetary and nonmonetary much the same as general price-level accounting, it becomes apparent that the effect of current value restatement on the current portions of the financial statements will be minimal. Because of this effect, only a sampling of ratios will be applied to the financial information.

## EXHIBIT 2

Ratio Analysis of Current Position

	Current or Working Capital Ratio = $\frac{\text{Current Assets}}{\text{Current Liab.}}$	Acid-Test or Quick Ratio = $\frac{\text{Quick Assets}}{\text{Current Liab.}}$
<u>Iowa Beef - 1976</u>		
	<u>Historical Cost</u>	<u>Current Value</u>
Working Capital Ratio	$\frac{141,472}{51,970} = 2.72$	$\frac{139,333}{49,831} = 2.80$
Acid-Test Ratio	$\frac{100,601}{51,970} = 1.94$	$\frac{100,601}{49,831} = 2.02$
<u>Iowa Beef - 1977</u>		
Working Capital Ratio	$\frac{149,061}{41,523} = 3.59$	$\frac{147,483}{39,945} = 3.69$
Acid-Test Ratio	$\frac{114,062}{41,523} = 2.75$	$\frac{114,062}{39,945} = 2.86$
<u>The Rouse Co. - 1976</u>		
Working Capital Ratio	$\frac{21,227}{15,877} = 1.34$	$\frac{21,227}{15,877} = 1.34$
<u>Barber-Ellis - 1974</u>		
Working Capital Ratio	$\frac{22,473}{13,468} = 1.67$	$\frac{22,722}{13,468} = 1.69$
Acid-Test Ratio	$\frac{12,105}{13,468} = .90$	$\frac{12,105}{13,468} = .90$

An important feature of a successful business is the ability to pay its liabilities as they become due. This ability is measured in terms of working capital and the lack of it is a common reason some new businesses fail. The ability of all these companies appears to be acceptable. As a rule of thumb, a current ratio of 2 to 1, and an acid-test ratio of 1 to 1, are considered adequate.<sup>4</sup> These may vary from one type of business to the next. For example, a company needing to buy large quantities of raw materials would need much more working capital than would a law firm. Judgement must be used when evaluating the results of ratios showing current position.

#### Ratios That Measure Equity Position

Ratios that reflect equity position may be the first item stockholders and creditors determine. These ratios give an indication of the net worth of the entity. As such, they present the financial strengths and weaknesses of a business.<sup>5</sup> A creditor may breathe a sigh of relief when he obtains a satisfactory ratio determining the creditor's equity in the company. These ratios are of a general nature and are not widely used, but they are viewed as rough measures of over or under expansion of fixed assets to the sources of long-term capital.

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<sup>4</sup>Ibid., pp. 1025, 1026.

<sup>5</sup>Ibid., p. 1029.



## EXHIBIT 3

Equity Position Financial Information

## IOWA BEEF PROCESSORS, INC.

(Amounts in Thousands) LIABILITIES AND STOCK- HOLDERS' EQUITY	1976		1977	
	Hist. Cost	Current Cost	Hist. Cost	Current Value
Current Liabilities	\$ 51,970	\$ 49,831	\$ 41,523	\$ 39,945
Deferred Income Taxes	11,460	--	14,066	--
Long-Term Debt	55,715	55,690	59,307	58,079
Stockholders' Equity	<u>134,292</u>	<u>190,848</u>	<u>162,631</u>	<u>188,090</u>
TOTAL LIAB. AND EQUITY	<u>253,437</u>	<u>296,369</u>	<u>277,527</u>	<u>286,114</u>

## THE ROUSE COMPANY

(Amounts in Thousands) LIABILITIES AND STOCK- HOLDERS' EQUITY	1976	1976
	Historical	Current Value
Total Liabilities	<u>\$378,420</u>	<u>\$378,420</u>
Stockholders' Equity:		
Capital Stock:		
\$6 Cumulative Preferred \$100 par, 24,991 issued	2,499	2,499
Common Stock, 1¢ par, 14,077,524 shares	141	141
Additional Paid-in Capital	20,171	20,171
Deficit	(6,491)	(6,491)
Revaluation Equity	--	112,873
Less: Common Treasury Stock 1,164,940 shares	(298)	(298)
Shareholders' Equity	<u>16,022</u>	<u>128,895</u>
TOTAL LIAB. AND EQUITY	<u>394,442</u>	<u>507,315</u>

## BARBER-ELLIS OF CANADA, LIMITED

(Amounts in Thousands) LIABILITIES AND STOCK- HOLDERS' EQUITY	1974	1974
	Historical	Current Value
Total Liabilities	<u>\$ 17,879</u>	<u>\$ 17,879</u>
Stockholders' Equity:		
Capital Stock	566	566
Contributed Surplus	45	45
Retained Earnings	10,242	7,002
Revaluation Surplus	--	4,319
Shareholders' Equity	<u>10,853</u>	<u>11,932</u>
TOTAL LIAB. AND EQUITY	<u>28,732</u>	<u>29,811</u>

It should be noted that in the preceding exhibit a revaluation equity amount is listed. This amount is the aggregate amount of the changes that have taken place in the restatement of the various assets. This amount has a significant effect on the amount of owners' equity. The ratio analysis of the above information is shown in the following exhibit.

## EXHIBIT 4

Ratio Analysis of Equity Position

Owners' Equity to Total Assets	$\frac{\text{Owners' Equity}}{\text{Total Assets}}$	Creditors' Equity to Total Assets	$\frac{\text{Total Liab.}}{\text{Total Assets}}$
Owners' Equity to Total Liab.	$\frac{\text{Owners' Equity}}{\text{Total Liab.}}$	Book Value Per Share - Common	$\frac{\text{Common Equity Outstanding}}{\text{Shares}}$
<u>Iowa Beef - 1976</u>			
Owners' Equity to Total Assets	$\frac{134,292}{253,437} = .53$	Creditors' Equity to Total Assets	$\frac{190,848}{296,369} = .64$
Creditors' Equity to Total Assets	$\frac{119,145}{253,437} = .47$	Book Value Per Share - Common	$\frac{105,521}{296,369} = .36$
Owners' Equity to Total Liabilities	$\frac{134,292}{119,145} = 1.13$	Book Value Per Share - Common	$\frac{190,848}{105,521} = 1.81$
Book Value Per Share - Common Stock	$\frac{134,292}{4,342,459} = 30.93$	Book Value Per Share - Common	$\frac{190,848}{4,342,459} = 43.95$
<u>Iowa Beef - 1977</u>			
Owners' Equity to Total Assets	$\frac{162,631}{277,527} = .59$	Creditors' Equity to Total Assets	$\frac{188,090}{286,114} = .66$
Creditors' Equity to Total Assets	$\frac{114,896}{277,527} = .41$	Book Value Per Share - Common	$\frac{98,024}{286,114} = .34$
Owners' Equity to Total Liabilities	$\frac{162,631}{114,896} = 1.42$	Book Value Per Share - Common	$\frac{188,090}{98,024} = 1.92$
Book Value Per Share - Common Stock	$\frac{162,631}{4,383,770} = 37.10$	Book Value Per Share - Common	$\frac{188,090}{4,383,770} = 42.91$

## Exhibit 4 (cont.)

<u>The Rouse Company - 1976</u>	<u>Historical Cost</u>		<u>Current Value</u>	
Owners' Equity to Total Assets	$\frac{16,022}{394,442}$	= .04	$\frac{128,895}{507,315}$	= .25
Creditors' Equity to Total Assets	$\frac{378,420}{394,442}$	= .96	$\frac{378,420}{507,315}$	= .75
Owners' Equity to Total Liabilities	$\frac{16,022}{378,420}$	= .04	$\frac{128,895}{378,420}$	= .34
Book Value Per Share - Common Stock	$\frac{13,373}{12,912,584}$	= 1.04	$\frac{126,246}{12,912,584}$	= 9.78
<u>Barber-Ellis - 1974</u>				
Owners' Equity to Total Assets	$\frac{10,853}{28,732}$	= .38	$\frac{11,932}{29,811}$	= .40
Creditors' Equity to Total Assets	$\frac{17,879}{28,732}$	= .62	$\frac{17,879}{29,811}$	= .60
Owners' Equity to Total Liabilities	$\frac{10,853}{17,879}$	= .61	$\frac{11,932}{17,879}$	= .67

NOTE: The number of shares of stock for Barber-Ellis were not available. Common stock equity for the Rouse Company was computed as follows:

	<u>Historical</u>	<u>Current Value</u>
Stockholders' Equity	\$ 128,895	\$ 16,022
\$6 Cumulative Preferred	(2,499)	(2,499)
Cumulative Dividends (24,991 x \$6)	(150)	(150)
Equity to Common Stock	<u>126,246</u>	<u>13,373</u>

Book value per share may impress investors if it is in excess of market value and is often used for comparative purposes with other companies.<sup>6</sup> From the computation of book value from the Rouse Company, it may be said that an investor would indeed be impressed.

<sup>6</sup>Ibid., p. 1031.



Ratios That Measure Operating Results

Increasing importance is being placed on the earning potential of an entity. A creditor may be unwilling to make loans or grant credit if an unhealthy profit picture exists in the prospective borrower's business, even though adequate collateral is available.<sup>7</sup> It would appear that management would prefer the method of accounting that presents the most "glorious" earnings figure.

The greatest change in the results of operations is a result of restated depreciation charges. Depreciation is computed on the value of the restated assets and can run into thousands of dollars of "extra" depreciation expense. Other adjustments are results of interest and debt obligations and restatement of imputed taxes. The result of such restatement, as shown in the following exhibit, is a lower reported net income. A major disadvantage of reporting a lower net income is that the IRS does not share the SEC's view of "reality" in reporting. Exhibit 6 will test the results of operations with a sampling of ratios. (The Rouse Co. provided only a current value balance sheet. The results of operations on a current value basis could not be obtained.)

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<sup>7</sup>Ibid., p. 1032.



## EXHIBIT 5

Results of Operations

## IOWA BEEF PROCESSORS, INC.

(Amounts in Thousands)	1976	1976
RESULTS OF OPERATIONS	<u>Historical</u>	<u>Current Value</u>
Sales	\$2,077,158	\$2,077,158
Less:		
Cost of Products Sold	1,990,176	1,991,188
Inventory Value Change	--	4,000
Gross Margin	<u>86,982</u>	<u>81,970</u>
Expenses	<u>58,204</u>	<u>58,751</u>
Net Results of Operations	28,778	23,219
Changes in Value	--	(136)
TOTAL NET RESULTS OF OPERATIONS	<u><u>28,778</u></u>	<u><u>23,083</u></u>

## IOWA BEEF PROCESSORS, INC.

(Amounts in Thousands)	1977	1977
RESULTS OF OPERATIONS	<u>Historical</u>	<u>Current Value</u>
Sales	\$2,023,765	\$2,023,765
Less:		
Cost of Products Sold	1,937,823	1,947,130
Inventory Value Change	--	(3,700)
Gross Margin	<u>85,942</u>	<u>80,335</u>
Expenses	<u>55,977</u>	<u>52,926</u>
Net Results of Operations	29,965	27,409
Change in Value	--	(3,519)
TOTAL NET RESULTS OF OPERATIONS	<u><u>29,965</u></u>	<u><u>23,890</u></u>

## BARBER-ELLIS OF CANADA, LIMITED

(Amounts in Thousands)	1974	1974
RESULTS OF OPERATIONS	<u>Historical</u>	<u>Current Value</u>
Sales	\$ 69,058	\$ 69,058
Less: Cost of Goods Sold	<u>50,390</u>	<u>51,374</u>
Gross Margin	18,668	17,684
Expenses (Including Value Change)	<u>15,391</u>	<u>15,700</u>
TOTAL NET RESULTS OF OPERATIONS	<u><u>3,277</u></u>	<u><u>1,984</u></u>

## EXHIBIT 6

Ratio Analysis of Operating Results

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}} \qquad \text{Return on Owners' Equity} = \frac{\text{Net Income}}{\text{Owners' Equity}}$$

$$\text{Earnings Per Share} = \frac{\text{Income Accruing to Common Stock}}{\text{Common Shares Outstanding}}$$

<u>Iowa Beef - 1976</u>	<u>Historical Cost</u>	<u>Current Value</u>
Profit Margin	$\frac{28,778}{2,077,158} = .014$	$\frac{23,083}{2,077,158} = .011$
Return on Owners' Equity	$\frac{28,778}{134,292} = .21$	$\frac{23,883}{190,848} = .12$
Earnings Per Share - Primary*	$\frac{28,778}{4,664,182} = 6.17$	$\frac{23,083}{4,664,182} = 4.95$
<u>Iowa Beef - 1977</u>		
Profit Margin	$\frac{29,965}{2,023,765} = .015$	$\frac{23,890}{2,077,158} = .013$
Return on Owners' Equity	$\frac{29,965}{162,631} = .18$	$\frac{23,890}{188,090} = .13$
Earnings Per Share - Primary	$\frac{29,965}{4,763,911} = 6.29$	$\frac{23,890}{4,763,911} = 5.01$
<u>Barber-Ellis - 1974</u>		
Profit Margin	$\frac{3,277}{69,058} = .047$	$\frac{1,984}{69,058} = .029$
Return on Owners' Equity	$\frac{3,277}{10,853} = .30$	$\frac{1,984}{11,932} = .17$
Earnings Per Share - Primary	$\frac{3,277}{462,200} = 7.09$	$\frac{1,984}{462,200} = 4.29$
- Fully Diluted	$\frac{3,277}{470,833} = 6.96$	$\frac{1,984}{470,833} = 4.21$

\*The reported earnings per share of Iowa Beef for 1976 was \$6.17 and for 1977 was \$6.29. The total number of shares and equivalents was determined by dividing reported income by reported earnings per share.

$$1976 = \$28,778,000 \div 6.17 = 4,664,182$$

$$1977 = \$29,965,000 \div 6.29 = 4,763,911$$

The most drastic change in operating results appears to occur in the earnings per share. Earnings per share may be the only number on the financial statements that some shareholders look at. After they have determined how much per share has been earned, they may disregard the rest of the financial statements completely.

#### Caution on the Use of Ratios

The ratio analysis is intended to be a method of "lifting" needed information from the financial statements. A single ratio in itself is meaningless and does not furnish a complete picture. A ratio becomes meaningful when compared with some standard. Ratios, like other statistical data, merely represent a convenient means of focusing the attention of the analyst on specific relationships which require further investigation. The ratios in no way take the place of "thinking" on the part of the analyst; they are not final in any sense of the word. A change in a ratio must be interpreted in the light of the variations in each of the two items, the relationship which is expressed by the ratio.<sup>8</sup>

With this limitation in mind and with the information obtained in this chapter, a closer look must now be taken to determine what this information means in terms of influence on the users of financial statements.

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<sup>8</sup>Ralph D. Kennedy and Stewart Y. McMullen, Financial Statements--Form, Analysis, and Interpretation (Homewood, Ill.: Richard D. Irwin, Inc., 1968), p. 345.

## CHAPTER V

### EVALUATION OF ANALYSIS

The information obtained by ratio analysis in Chapter Four has little meaning when viewed as a single index. The comparison of these numbers from both historical and current costs should provide evidence to determine whether any material effect on the users of this information will result.

#### Evaluation of Current Position

The change in current position was minimal. This is a direct result of the separation of monetary and nonmonetary items. Monetary items are not restated as such and yield approximately the same ratios in all cases. The readers of either historical cost or current value should not be materially influenced by the ratio analysis applied to such information. The user should determine that these companies are in excellent shape as far as current position is concerned.

#### Evaluation of Equity Position

In evaluation of equity position it must be remembered that when stockholder's equity rises in relation to total liabilities, the margin of protection to the creditor goes up.<sup>1</sup> However, it should not be overlooked that it is

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<sup>1</sup>Simon and Smith, Intermediate Accounting, p. 916.



often advantageous to supplement funds invested with a certain amount from creditors. The information below must be evaluated with this in mind.

## EXHIBIT 7

Summary of Equity Position Ratios

<u>Company</u>	<u>Ratio*</u>	<u>Hist. Cost</u>	<u>Current Value</u>	<u>Increase (Decrease)</u>
Iowa Beef 1976	OE/TA	.53	.64	21%
	CE/TA	.47	.36	(23%)
	OE/TL	1.13	1.81	60%
	BV	30.93	43.95	42%
Iowa Beef 1977	OE/TA	.59	.66	12%
	CE/TA	.41	.34	(17%)
	OE/TL	1.42	1.92	35%
	BV	37.10	42.91	16%
Rouse Co. 1976	OE/TA	.04	.25	525%
	CE/TA	.96	.75	(22%)
	OE/TL	.04	.34	750%
	BV	1.04	9.78	840%
Barber-Ellis 1974	OE/TA	.38	.40	5%
	CE/TA	.62	.60	(3%)
	OE/TL	.61	.67	10%

\*OE/TA - Owners' equity to total assets  
 CE/TA - Creditors' equity to total assets  
 OE/TL - Owners' equity to total liabilities  
 BV - Book value per share of common stock

Iowa Beef, Inc. appears to be consistent on a comparative basis for 1976 and 1977. The percentage figures vary somewhat, but an overall view of the two years taken together does not produce any significant changes. In analyzing within each individual period it will be noted that owners' equity over total liabilities has increased

significantly in both years. A creditor would undoubtedly be more inclined to give credit to Iowa Beef if he had in his hand a current value statement as opposed to a historical cost statement.

Book value for Iowa Beef has also increased substantially. The large gain from 1976 to 1977 in Book Value is a direct result of reduced liabilities in 1977, and will account for the small change in current values from 1976 to 1977.

In analyzing the information for the Rouse Co. it is difficult not to be shocked by the percentage changes. It must be pointed out however, that small decimals are being used and the change may not be as dramatic as it appears. Even though the numbers may be playing tricks on the analysis, the effect of current values on the Rouse Co. is significant. The Rouse Co. appears to be financed heavily through credit. By restating, the amount of owners' equity to liabilities increases from 4 percent to 34 percent. This change may cause a creditor to grant additional credit to the Rouse Co., when he might not have if he had known owners' equity is only 4 percent of total assets.

The dramatic change in book value for the Rouse Co. can be traced to their revaluation of equity, which totals nearly \$113 million dollars. To find someone who would not consider this a material amount may be difficult.

Evaluation of Results of Operations

The purpose of determining a return on owners' equity is to compute a rate that reflects the use of leverage (the use of borrowed funds) to generate net income. This rate is of interest to the investor who must reconcile the risk of a highly leveraged company with the potentially greater profitability.<sup>2</sup> One other point to keep in mind is that the earnings per share figure was considered of such importance that they were required to be presented prominently on the face of the statements by APB Opinion No. 15.<sup>3</sup>

EXHIBIT 8

Summary of Operating Results Ratios

<u>Company</u>	<u>Ratio*</u>	<u>Hist. Cost</u>	<u>Current Value</u>	<u>Increase (Decrease)</u>
Iowa Beef 1976	PM	.014	.011	(21%)
	ROI	.21	.12	(43%)
	EPS	6.17	4.95	(20%)
Iowa Beef 1977	PM	.015	.012	(20%)
	ROI	.18	.13	(28%)
	EPS	6.29	5.01	(20%)
Barber-Ellis 1974	PM	.047	.029	(38%)
	ROI	.30	.17	(43%)
	EPS-P	7.09	4.29	(40%)
	EPS-F	6.96	4.21	(40%)

\*PM - Profit margin (percent)

ROI - Return on owners' equity (percent)

EPS-P - Earnings per share in dollars

EPS-F - Fully diluted EPS in dollars

<sup>2</sup>Ibid., p. 922.

<sup>3</sup>Ibid., p. 924.

Iowa Beef again appears to have a consistent method of reporting from 1976 to 1977. There are no major changes involved with the comparability between periods. The effect of restatement within the year is consistent in all companies--all figures are lower.

Iowa Beef experiences a 20 percent loss in earnings per share for both years. If current values report reality it is easy to see why shareholders may be dissatisfied with earnings. The rate of return on equity also may be cause for concern. In 1976 the return was cut nearly in half.

In the case of Barber-Ellis, the change is more substantial than that of Iowa Beef. All reported earnings ratios are down approximately 40 percent. Again, this may cause more than mild confusion for stockholders in evaluating the current value statements.

The lower rate of return on owners' equity indicates a larger return for creditors' equity. Can it be said that nearly one-half of reported income is misstated on historical cost statements? If this is indeed true, historical cost statements should be abandoned! If not, what will be gained by the change to current values?

It is regrettable that the Rouse Co. did not restate their income statement as well as their balance sheet; an income statement would have proved to be another interesting experience.



## CHAPTER VI

### SUMMARY AND CONCLUSION

In summarizing the results of this paper, it can be said that current value accounting will need a definite form and criteria before many conservative accountants will release their grip on the "dependable" historical cost statements.

A significant event during recent years that has had a significant effect on reporting is the issuance of ASR 190 by the SEC. The reasoning behind the issuance is not clear, but it is possible that the SEC decided to intervene, when it appeared that the FASB was about to issue an opinion on general price-level statements. The delay the FASB had in reaching a conclusion may have convinced many, including the SEC, that the method at hand would not produce the desired results.

The advocates of current value accounting find their strongest support in the argument that historical cost statements overstate "real" net income. It appears that the opponents do not even argue this point. The opponents hold fast to the idea of "don't abandon something for nothing." They find support in the fact that current value has no set criteria and application is vulnerable to subjectiveness and

bias on the part of auditors and appraisers. This point does cause concern among the accounting profession.

When analyzing financial statements it is readily apparent that current value produces a lower net income. This is possibly its greatest intended purpose. The earnings per share under current value accounting decrease significantly, and this is sometimes a desired result. The only adverse effect is the concern of management that reporting lower net income may endanger their position with the stockholders.

From the information obtained it can be concluded that there will be no material effect on the users when analyzing the current positions of the financial statements. This is a direct result of dividing items into monetary and nonmonetary categories.

When considering the equity position and results of operations, the same conclusion cannot be reached. The revaluation amounts that result from current value restatement can cause various relationships to increase dramatically while others remain nearly unchanged.

The real economic net earnings is probably somewhere between historical and current value. The deficiencies of a lack of criteria for current value is much the same as the "cruel" fact that historical cost overstates earnings. The effect on the shareholder when faced with this problem may be one of total confusion.

In reviewing the ratio analysis, it appears that there is reporting consistency between comparative periods, but it dissipates when comparing historical to current value within the single period.

In conclusion, the effect on the users of financial statements is varied. The very real possibility exists that users will become confused with the current value basis and may cause them to make judgements that are more unsound than with just historical statements alone. The key is education and experience. With time and use the user will become familiar with the methods and analyze them accordingly. At this point it may be said that current value restatement will indeed materially affect the users of financial statements and a mild state of confusion will not be uncommon when users attempt to analyze the financial statements.





Iowa Beef Processors, Inc. and Subsidiaries

**Current-Value Consolidated Balance Sheet**

October 30, 1976

	Current Value Basis	Historical Cost Basis
<b>Assets</b>		
CURRENT ASSETS:		
Cash .....	\$ 11,582,000	\$ 11,582,000
Accounts receivable, less allowance for doubtful accounts .....	89,019,000	89,019,000
Inventories .....	38,199,000	38,199,000
Deferred tax benefit .....	—	2,139,000
Prepaid expenses .....	533,000	533,000
Total Current Assets .....	139,333,000	141,472,000
OTHER ASSETS .....	1,455,000	1,455,000
PROPERTY, PLANT AND EQUIPMENT:		
Land and land improvements .....	16,284,000	11,696,000
Buildings and stockyards .....	77,390,000	43,480,000
Equipment .....	127,053,000	82,268,000
Construction in progress .....	4,251,000	4,251,000
	224,978,000	141,695,000
Less accumulated depreciation .....	69,397,000	34,022,000
	155,581,000	107,673,000
DEFERRED FINANCING COSTS .....	—	2,837,000
	\$296,369,000	\$253,437,000
 <b>Liabilities and Stockholders' Equity</b>		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities .....	\$ 30,992,000	\$ 33,131,000
Federal and state income taxes .....	16,514,000	16,514,000
Current maturities on long-term obligations .....	2,325,000	2,325,000
Total Current Liabilities .....	49,831,000	51,970,000
DEFERRED INCOME TAXES .....	—	11,460,000
LONG-TERM OBLIGATIONS .....	55,690,000	55,715,000
CONTINGENCIES .....	—	—
STOCKHOLDERS' EQUITY .....	190,848,000	134,292,000
	\$296,369,000	\$253,437,000

See notes to current-value consolidated financial statements.

Iowa Beef Processors, Inc. and Subsidiaries

# Consolidated Statement of Net Results of Operations and Changes in Value

Year (52 weeks) ended October 30, 1976

	Current Value Basis	Historical Cost Basis
RESULTS OF OPERATIONS:		
Sales .....	\$2,077,158,000	\$2,077,158,000
Less — Cost of products sold .....	1,991,188,000	1,990,176,000
— Inventory value change .....	4,000,000	—
	<u>1,995,188,000</u>	<u>1,990,176,000</u>
	81,970,000	86,982,000
Expenses:		
Selling, general and administrative .....	24,746,000	24,374,000
Interest expense .....	3,703,000	3,666,000
Income taxes .....	30,302,000	30,164,000
	<u>58,751,000</u>	<u>58,204,000</u>
Net results of operations and inventory value change .....	23,219,000	28,778,000
CHANGES IN VALUE:		
Change in current costs of depreciable assets during the year .....	9,011,000	—
Change in current value of debt and accruals .....	(1,153,000)	—
Amount required to recognize impact on stockholders' equity of increase in the general price level during the year .....	(7,994,000)	—
TOTAL OF NET RESULTS OF OPERATIONS AND CHANGES IN VALUE .....	<u>\$ 23,083,000</u>	<u>\$ 28,778,000</u>

## Current-Value Consolidated Statement of Stockholders' Equity

Year (52 weeks) Ended October 30, 1976

	Current Value Basis	Historical Cost Basis
Balance, November 2, 1975 .....	\$ 161,824,000	\$ 107,557,000
Amount required to recognize impact on stockholders' equity of increase in general price level during the year .....	7,994,000	—
Restated at November 2, 1975 .....	169,818,000	107,557,000
Common stock options exercised .....	488,000	477,000
Shares acquired for treasury .....	(771,000)	(771,000)
Cash dividends paid .....	(1,770,000)	(1,749,000)
Net results of operations and changes in value during the year .....	<u>23,083,000</u>	<u>28,778,000</u>
Balance, October 30, 1976 .....	<u>\$ 190,848,000</u>	<u>\$ 134,292,000</u>

See notes to current-value consolidated financial statements.

## Current Value Consolidated Balance Sheet

Amounts in thousands

	Current Value		Historical Cost
	October 29, 1977	October 30, 1976	October 29, 1977
<b>Assets</b>			
CURRENT ASSETS:			
Cash .....	\$ 15,549	\$ 11,582	\$ 15,549
Accounts receivable, less allowance for doubtful accounts .....	98,513	89,019	98,513
Inventories .....	32,239	38,199	32,239
Deferred tax benefit .....	—	—	1,578
Prepaid expenses .....	1,182	533	1,182
Total Current Assets .....	147,483	139,333	149,061
PROPERTY, PLANT AND EQUIPMENT:			
Land and land improvements .....	19,136	16,284	13,224
Buildings and stockyards .....	73,875	77,390	43,675
Equipment .....	158,236	127,053	98,541
Construction in progress .....	11,101	4,251	10,830
	262,348	224,978	166,270
Less—accumulated depreciation .....	83,111	69,397	42,292
—imputed income taxes .....	41,696	35,925	—
	137,541	119,656	123,978
OTHER ASSETS .....	1,090	1,966	4,488
	<u>\$286,114</u>	<u>\$260,955</u>	<u>\$277,527</u>
<b>Liabilities and Stockholders' Equity</b>			
CURRENT LIABILITIES:			
Notes payable .....	\$ 4,000	\$ —	\$ 4,000
Accounts payable and accrued liabilities .....	32,121	30,992	33,699
Federal and state income taxes .....	1,805	16,514	1,805
Current maturities on long-term obligations .....	2,019	2,325	2,019
Total Current Liabilities .....	39,945	49,831	41,523
DEFERRED INCOME TAXES .....	—	—	14,066
LONG-TERM OBLIGATIONS .....	58,079	54,284	59,307
STOCKHOLDERS' EQUITY .....	188,090	156,840	162,631
	<u>\$286,114</u>	<u>\$260,955</u>	<u>\$277,527</u>

See notes to current-value consolidated financial statements.



Amounts in Thousands

	Year (52 Weeks) Ended		
	Current Value		Historical Cost
	October 29, 1977	October 30, 1976	October 29, 1977
<b>RESULTS OF OPERATIONS:</b>			
Sales .....	\$2,023,765	\$2,077,158	\$2,023,765
Less—cost of products sold .....	1,947,130	1,991,188	1,937,823
—inventory value change .....	(3,700)	4,000	—
	<u>1,943,430</u>	<u>1,995,188</u>	<u>1,937,823</u>
	80,335	81,970	85,942
<b>Expenses:</b>			
Selling, general and administrative .....	27,926	24,746	27,787
Interest expense .....	3,258	3,703	3,281
Income taxes .....	21,742	30,302	24,909
	<u>52,926</u>	<u>58,751</u>	<u>55,977</u>
Net results of operations and inventory value change .....	27,409	23,219	29,965
<b>CHANGES IN VALUE:</b>			
Change in current costs of depreciable assets during the year .....	6,383	5,709	—
Change in current value of debt and interest .....	173	(1,265)	—
Change in other imputed taxes .....	(1,072)	1,628	—
Amount required to recognize impact on stockholders' equity of increase in the general price level during the year ..	(9,003)	(6,402)	—
<b>TOTAL OF NET RESULTS OF OPERATIONS AND CHANGES IN VALUE .....</b>	<u>\$ 23,890</u>	<u>\$ 22,889</u>	<u>\$ 29,965</u>

Amounts in Thousands

	Year (52 Weeks) Ended		
	Current Value		Historical Cost
	October 29, 1977	October 30, 1976	October 29, 1977
Balance at beginning of year .....	\$156,840	\$ 129,602	\$ 134,292
Amount required to recognize impact on stockholders' equity of increase in general price level during the year .....	9,003	6,402	—
Restated balance at beginning of year .....	165,843	136,004	134,292
Common stock options exercised .....	512	488	502
Shares acquired for treasury .....	(204)	(771)	(194)
Treasury shares issued .....	259	—	250
Cash dividends paid .....	(2,210)	(1,770)	(2,184)
Net results of operations and changes in value during the year .....	23,890	22,889	29,965
Balance at end of year .....	<u>\$188,090</u>	<u>\$ 156,840</u>	<u>\$ 162,631</u>

See notes to current-value consolidated financial statements.



## Appendix A

## BARBER-ELLIS OF CANADA, LIMITED

Current Replacement Cost Balance Sheet  
As at December 31, 1974

ASSETS			LIABILITIES		
	Current Replacement Cost (Note 1)	Historical Cost (Note 3)		Current Replacement Cost (Note 1)	Historical Cost (Note 3)
<b>Current:</b>			<b>Current:</b>		
Cash .....	\$ 29,783	\$ 29,783	Bank indebtedness	\$ 7,573,983	\$ 7,573,983
Accounts receivable .....	12,074,945	12,074,945	Accounts payable and accrued liabilities .....	4,109,189	4,109,189
Inventories .....	10,366,804	10,117,804	Income taxes .....	1,296,693	1,296,693
Prepaid expenses .	249,545	249,545	Dividends—pref- erence shares ..	700	700
	\$22,721,077	\$22,472,077	Current portion of long-term debt ..	486,650	486,650
				\$13,467,215	\$13,467,215
Property, plant and equipment .....	\$15,164,198	\$11,261,927	Deferred income taxes .....	\$ 278,362	\$ 278,362
Accumulated depreciation .....	(8,074,486)	(5,817,772)	Long-term debt (Note 1) .....	4,133,650	4,133,650
Unamortized excess of purchase price of subsidiaries over fair value of net assets acquired .	—	816,067		\$17,879,227	\$17,879,227
			<b>SHAREHOLDERS' EQUITY</b>		
			Capital Stock .....	\$ 565,705	\$ 565,705
			Contributed surplus	45,000	45,000
			Retained earnings .	7,001,653	10,242,367
			Revaluation surplus	4,319,204	—
	\$29,810,789	\$28,732,299		\$29,810,789	\$28,732,299

Current Replacement Cost Statement  
of Earnings and Retained Earnings  
For the year ended December 31, 1974

	Current Replacement Cost (Note 2)	Historical Cost (Note 3)
Net Sales .....	\$69,058,300	\$69,058,300
Costs and Expenses		
Cost of products sold .....	\$51,373,580	\$50,389,580
Selling, general and administration ...	10,705,281	10,705,281
Depreciation and amortization ....	1,095,567	786,969
Interest—long-term debt .....	381,884	381,884
Interest—current ..	590,284	590,284
	\$64,146,596	\$62,853,998
Earnings before income taxes ...	\$ 4,911,704	\$ 6,204,302
Provision for income taxes ...	2,927,442	2,927,442
Net Earnings .....	\$ 1,984,262	\$ 3,276,860
Retained earnings, beginning of year	7,939,344	7,939,344
	\$ 9,923,606	\$11,216,204
Adjustment of prior years' deprecia- tion on current replacement cost of plant and equipment .....	\$ 1,948,116	—
Dividends .....	973,837	\$ 973,837
Retained Earn- ings, End of Year	\$ 7,001,653	\$10,242,367
Earnings Per Share		
Basic .....	\$ 4.30	\$ 7.09
Fully diluted .....	4.22	6.96

Statement of Revaluation Surplus  
For the year ended December 31, 1974

Revaluation of physical assets to reflect current replacement cost as at December 31, 1974	
Inventories .....	\$ 249,000
Property, plant and equipment ...	3,902,271
Excess of purchase price over fair value of assets acquired .....	(816,067)
Revaluation of cost of products sold during the year ended De- cember 31, 1974	
Portion of 1974 earnings deter- mined on historical cost basis which are required to replace inventory sold at the current cost in effect at the date of sale	984,000
Revaluation surplus December 31, 1974 .....	\$ 4,319,204

Report on Supplementary Financial Statements

To the Shareholders,  
Barber-Ellis of Canada, Limited.

In conjunction with our examination of and report on the financial statements of Barber-Ellis of Canada, Limited for 1974 we have also examined the accompanying supplementary financial statements which have been prepared on a current replacement cost basis.

Uniform criteria for the preparation and presentation of such supplementary financial information have not yet been established and accordingly, acceptable alternatives are available as to their nature and content. In our opinion, however, the accounting basis described in the notes to the supplementary financial statements has been applied as stated and is appropriate in these circumstances.

Touche Ross & Co.  
Chartered Accountants

Toronto, Ontario  
February 21, 1975

The Rouse Company  
and Subsidiaries

# Consolidated Cost Basis and Current Value Basis Balance Sheets

May 31, 1976 and 1975  
(in thousands)

Assets	— 1976 —		1975
	Current Value Basis (note 1)	Cost Basis	Cost Basis
Property and deferred costs of projects (notes 3 and 9):			
Operating properties:			
Current value .....	\$372,105		
Cost .....		\$314,205	\$297,766
Less accumulated depreciation and amortization .....		54,230	50,542
		<u>259,975</u>	<u>247,224</u>
Construction and development in progress .....	60,075	60,075	60,226
Pre-construction costs, net .....	7,761	7,761	7,723
Other furniture, fixtures and equipment, net .....	4,459	3,734	4,105
Net property and deferred costs of projects .....	<u>444,400</u>	<u>331,545</u>	<u>319,278</u>
Mortgage banking (notes 4 and 9):			
Notes receivable .....	15,760	15,742	8,730
Accounts receivable .....	674	674	855
	<u>16,434</u>	<u>16,416</u>	<u>9,585</u>
Investment operations (notes 5 and 9):			
Notes receivable .....	15,190	15,190	20,827
Real estate owned .....	9,755	9,755	12,219
Accounts receivable .....	203	203	708
	<u>25,148</u>	<u>25,148</u>	<u>33,754</u>
Less reserve for possible loan losses .....	3,950	3,950	2,405
	<u>21,198</u>	<u>21,198</u>	<u>31,349</u>
Net investment in Rouse-Wates (note 6) .....	3,364	3,364	1,650
Due from HRD (note 7) .....	692	692	755
Other assets and deferred charges, primarily prepaid expenses and deposits .....	7,364	7,364	7,078
Accounts and notes receivable (note 8) .....	10,058	10,058	9,163
Cash and temporary investments .....	<u>3,805</u>	<u>3,805</u>	<u>6,007</u>
<b>Total assets</b> .....	<u>\$507,315</u>	<u>\$394,442</u>	<u>\$384,865</u>



## Liabilities, Deferred Credits and Shareholders' Equity

	— 1976 —		1975
	Current Value Basis (note 1)	Cost Basis	Cost Basis
Debt (note 9):			
Debt not carrying a parent company guarantee of repayment:			
Debt of operating properties	\$208,962	\$208,962	\$236,627
Debt of properties under development	17,484	17,484	4,229
Debt of parent company and debt carrying a parent company guarantee of repayment:			
Debt of operating properties	44,265	44,265	18,984
Debt of properties under development	23,888	23,888	23,827
Term loan credit notes payable:			
Parent company	18,250	18,250	25,400
Investment operations	13,800	13,800	19,481
Senior subordinated notes payable	12,096	12,096	13,432
Other debt	4,097	4,097	4,798
Notes payable—Mortgage banking	15,522	15,522	8,640
Accounts payable and accrued expenses	15,877	15,877	17,486
Commitments and contingencies (notes 4, 6, 13, 14 and 16)			
Deferred credits:			
Deferred gains on sale-leasebacks of property (note 2)	2,243	2,243	2,275
Deferred loss associated with sales of interests in retail centers (note 11)	1,936	1,936	1,939
Shareholders' equity:			
Capital stock (note 12):			
6 Cumulative Preferred stock of \$100 par value per share. Authorized 25,000 shares; issued 24,991 shares	2,499	2,499	2,499
Common stock of 1¢ par value per share. Authorized 20,000,000 shares; issued 14,077,524 shares in 1976 and 13,991,524 shares in 1975	141	141	140
Total capital stock	2,640	2,640	2,639
Additional paid-in capital	20,171	20,171	20,103
Deficit	(6,491)	(6,491)	(14,697)
Valuation equity (note 1 (c))	112,873		
	129,193	16,320	8,045
Common stock held in treasury, 1,164,940 shares at cost	298	298	298
Total shareholders' equity	128,895	16,022	7,747
Total liabilities, deferred credits and shareholders' equity	\$507,315	\$394,442	\$384,865



- Construction and development in progress and pre-construction costs are carried at the same values as in the cost basis financial statements—values which represent the lower of cost or net realizable value. While the company believes that the properties under construction (some of which will open in the next several months) have value in excess of stated cost, management has taken the more conservative position in not adjusting the cost basis by any value increment.
- Other furniture, fixtures and equipment is valued at its current replacement cost which was determined by reference to recent prices of similar assets and estimates of the current cost to duplicate similar assets. The gross replacement cost of furniture, fixtures and equipment is \$5,856,000, which reflects an increase of \$941,000 over the cost basis. The related accumulated depreciation and amortization was \$1,397,000 after an increase of \$216,000 to reflect that portion of the increase in current replacement cost of the assets which would have been charged to operations through May 31, 1976.
- Mortgage banking notes receivable represent mortgage notes held for sale to long-term investors usually under pre-arranged take-out commitments from such investors. The mortgages are purchased from developers at a price which may be different from the price at which the company will ultimately resell such mortgages. Those notes for which sale commitments have been pre-arranged are carried at the commitment price. The remainder of the notes are carried at their market value. This value exceeds the cost basis by \$18,000 at May 31, 1976.
- The following resources are carried on the current value balance sheet at the lower of cost or net realizable value—the same stated value as on the cost basis balance sheet:
  - Mortgage banking accounts receivable (net of doubtful receivable reserves);
  - accounts of the Investment operations, including notes and accounts receivable and real estate owned (net of loan loss reserves);
  - the company's net investment in Rouse-Wates (net of liquidation reserves);
  - amounts due from HRD;
  - other assets and deferred charges;
  - accounts and notes receivable (net of doubtful receivable reserves); and
  - cash and temporary investments

The stated values of these accounts represent their current value as the underlying assets will be realized in the relatively near-term.

- All liability accounts are carried at the same stated value as in the cost basis balance sheet. Long-term debt relating to our operating properties is carried at the same amount as in the cost basis statement because the difference between the current value and cost basis of such debt, if any, is an integral part of the revaluation equity attributable to operating properties. A significant portion of the debt which is not specifically related to our operating properties carries interest rates which fluctuate with the prime interest rate. Therefore, the outstanding balance of this debt represents its current value. This is also the case with the notes payable—Mortgage banking

The application of the foregoing methods for estimating current value represents the best judgment of management based upon its current evaluation of the economy and money markets today and in the future. These kinds of judgments regarding the economy and money markets are not subject to precise quantification or verification, and may change from time to time as economic and market factors, and management's evaluation of them, change.

### (c) Revaluation equity

The aggregate difference between the current value basis and cost basis net book value of the company's assets is carried as revaluation equity in the shareholders' equity section of the consolidated current value basis balance sheet. The components of this revaluation equity at May 31, 1976 are as follows:

Operating properties:	
Value of equity interests. . . . .	\$113,820,000
Outstanding balance of debt related to equity interests, excluding \$2,015,000 of debt related to fringe land. . . . .	251,212,000
	<u>365,032,000</u>
Value of fringe land. . . . .	7,073,000
Total asset value. . . . .	<u>372,105,000</u>
Depreciated cost of operating properties. . . . .	<u>259,975,000</u>
Revaluation equity in operating properties. . . . .	112,130,000
Mortgage banking notes receivable. . . . .	18,000
Other furniture, fixtures and equipment, not of accumulated depreciation and amortization. . . . .	<u>725,000</u>
Total revaluation equity. . . . .	<u>\$112,873,000</u>

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