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Adjusting for Inflationary Distortion of Historical Cost Financial Statements

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ADJUSTING FOR INFLATIONARY DISTORTION OF HISTORICAL COST FINANCIAL STATEMENTS

by

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CHAPTER I

During the last decade, the impact of rising inflation on the American economy has received considerable attention. The problem has been particularly apparent during the last several years, with the government attempting to control the rapid rise of inflation, the economist attempting to explain it, and the American public, temporarily at least, accepting it as a fact of life. It is very apparant, devistatingly so in many instances, to the American wage earner that his dollar is buying considerably less at the present time than a short while ago. The steady and rapid decline in the purchasing power of the dollar has brought into the limelight an important question in the minds of those involved in the business environment: How much reliance can be placed on present historical cost financial statements?

The accounting profession and the business world as a whole have always been extremely concerned with assuring themselves of fair financial reporting by management. In attempting to achieve this goal, the necessity for a common unit of measurement to compare various assets, liabilities, and equities was apparant. In the United States, the dollar was accepted to fulfill this requirement in financial reporting, under the assumption the dollar was a stable unit of measure. The general acceptance of the dollar as a unit of measure has not gone by without definitional problems however. Because of the change in general purchasing power of the dollar in periods of inflation or deflation, the accounting principle which recognizes the dollar as a unit of measurement in financial accounting without recognition of the changes of its general purchasing power has recently been the center of attention in the controversy over accounting for inflation.

In the past, the accounting profession has held steadfast to its utilization of the cost principle in financial reporting. Among the assumptions and justifications underlying this position were that the dollar was a stable unit of measure and that the purchase price of the asset measured in cash or cash equivilent was an objective, verifiable statistic. Accountants have recently become more aware of the fact that the justifications are not completely valid and it may be time to further examine the underlying assumptions. This thought is evidenced by such indicators as the consumer price index, which is utilized as a measurement of inflation. As measured by the consumer price index, the annual rate of inflation, while averaging three percent from 1946 to 1972, was measured at approximately six percent in the years 1969 to 1972. The increased rate displayed in those three years has been followed by a rate which has been increasing at a substantially rapid pace for subsequent periods. The apparent materiality of the current change in purchasing power of the dollar has seriously deteriorated the assumption of the stability of the dollar in its use as a unit of measure.[1]

The use of financial statements by owners and creditors has always played a role in the accounting profession's determination of the information required of financial reporting. The profession has recognized the fact that financial accounting information may be directed toward the common needs of one or more users or may be directed toward specialized needs. In this regard, the American Institute of Certified Public Accountants has deemed that the emphasis in financial accounting should more appropriately be based on general purpose information. This is following the presumption that a significant number of users need similar information, and that the costs and possible confusion that might result from specialized reporting outweigh the advantages to be obtained.[2]

It is generally felt that accounting is a communicative process primarily between management and investors that should contain relevant information on which to base an investment decision. The users of financial statements are normally in search of an appropriate measure of performance and status in order to make an informed business decision in accordance with todays economic environment. The data a user commonly attaches economic substance to and looks to for answering his investment questions include earnings per share, the enterprise's ability to pay future dividends and interest, and the worth of the enterprise's stock. With the steady decline in the value of the dollar, income and reporting based upon historical cost typically result in an understatement of costs consumed resulting in an inflated income. In examining the data with which he is concerned, which is based in part at least on the inflated income, the investor might well arrive at a different opinion as to the economic outlook than had he been presented an uninflated picture.[3]

The inflated income as commonly presented is due largely to the fact that the reported financial position is typically a mixture of old dollars in accounts such as land, buildings, and other fixed assets, and the new dollars in such accounts as cash, other current assets, and current liabilities. Inherent in this mixture is the fact that inflationary profits are most probably present. The inflationary items erroneously reported as profits come mainly from three sources:

1. Failing to recognize the loss in purchasing power of cash available after collecting the accounts receivable and paying the current liabilities;
2. Charging costs of goods sold with the original dollar cost instead of the current dollar cost; and

3. Understating the depreciation provisions by charging operations with the original dollar costs rather than the present inflated dollar amounts.

Understanding and having the capacity to recognize and initiate a solution to overcome these dificiencies is no simple task. The concern that many investors do not possess such tools has resulted in serious considerations for taking into account the effect of inflation in the area of financial reporting.[4]

Since the objective of many users is to predict, compare, and evaluate cash flows, it is felt that accounting, to be useful, must communicate the status and change in economic resources. The measurement of such resources will most likely continue to be defined and measured in terms of money. However, with regard to the most beneficial financial data to utilize in arriving at a decision, the question emerges: Should the measurement of the financial resources be in historical dollars, the original investment adjusted for the rise or fall of the general purchasing power of the dollar, or the value of the specific resource in terms of current dollars?[5]

As investors become increasingly more aware of the problem of inflation's impact on financial statements, they will be focusing their attention toward a method of determining which companies appear to have the best understanding of the nature of inflation and the most effective program for minimizing its effects. With regard to the almost certain upcoming pressures from investors, the movement toward a form of price-level adjusted financial statements becomes increasingly stronger.

Managers also would most likely find price-level adjusted statements to be an aid in their planning. By comparing price-level statements with unadjusted statements, they may more readily perceive the nature and extent of the impact of inflation upon their operations. As managers become more familiar with the adjustments, they will find themselves in a better position to use this data in the making of decisions involving the interplay of inflation and the timing of proposed changes in selling prices, inventory turnover, estimated increases in material and labor costs, and the renting or purchasing of essential assets.[6]

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[1]Karl E. Fraedrich, "Inflation and Financial Reporting," Management Accounting, v. 55 (April, 1974), p. 18.

[2]Accounting Principles Board of the American Institute of Certified Public Accountants. APB Accounting Principles Current Text, Statement No. 19. Financial Statements Restated for General Price-Level Changes (Chicago, Ill., 1973). p. 184.

[3]George Hill, "Accounting Has a Credibility Problem -- We Must Account For Inflation," The Arthur Anderson Chronicle, v. 34, No. 4 (October, 1974), p.p. 50, 55.

[4]John R. O'Donnel, "Are Your Earning What You Think You Are?" The Arthur Anderson Chronicle, v. 34, No. 3 (July, 1974), p. 55.

[5]Lawrence Revsine and Jerry J. Weygandt, "Accounting for Inflation: The Controversy," The Journal of Accountancy, October, 1974, p. 73.

[6]Frank T. Weston, "Adjust Your Inflation for Accounting," Harvard Business Review, January-February, 1975, p. 24.

CHAPTER II

It is felt by a large segment of the business environment that there is a distinct and real need at the present time to account for the effect of inflation upon an enterprises' resources. One view point expressed on the subject by William Blacicle, retired board chairman of Caterpillar Tractor Company, indicated that we have been hypnotized by the dollar figure and have not been looking at performance in terms of real wealth created or consumed.[1]

With the present double digit inflation and the growing materiality of the amounts involved, many take the position along side Arthur Anderson & Co. who feel current value information of some nature is necessary to reflect economic reality. This information would appear to be of great relevance to all interested parties, and adoption of a "persuasive value attitude" would probably provide more prudent financial information in many cases by putting an emphasis on the recognition of changes in value, whether up or down.[2]

Many of the leading arguments in favor of the adoption of an alternative method of reporting economic activities certainly have a great deal of merit considering the present degree of inflation. Some of the more common arguments in favor of price-level accounting include:

1. Reporting income under historical cost based statements tends to overstate net income during a period of inflation, particularly when there is a large investment in fixed assets involved.
2. The use of depreciation based on historical cost does not allow

recovery of sufficient purchasing power to replace the asset at current prices.

3. The balance sheet does not reflect current values of virtually all accounts outside the current classifications.
4. The statement users can better evaluate managements effectiveness of maintaining the current dollar equivalent of the assets invested and can better analyze the enterprise in terms of current economic conditions.
5. Disclosure of gains and losses on monetary items provides information relevent to evaluating monetary management.
6. Financial statements reflecting current dollars would be extremely useful to investors.[3]

There is also the existing argument that the historical dollar statements can be misleading, particularly in countries where inflation is rampant, because of the mixtures of current purchasing power dollars and historical dollars. This contention revolves around the utilization of the dollar in financial statements as a measurement standard with the assumption the dollar is a stable unit. It is recognized of course, that this is not the case. This differential between the dollar as a unit of money as opposed to a unit of measure must be looked at in perspective. By restating financial statements, particularly with the use of a general price index, the measurement standard, the dollar, would be changed from a unit of money to a unit of general purchasing power. Such restatement would merely be an extension of historical cost which would change the standard of measurement, not the accounting principle.[4]

From the expansion of the argument that adjusted statements would be useful to investors comes the question of how sophisticated is the user of the statement. It is suggested that the readers attempt to make inferences involving the impact of inflation on the historical cost statements cannot be more than very crude estimations. This is due to the fact that the rate of change in the purchasing power of the dollar has not been constant and the effect of change in the purchasing power of money will vary between companies according to the individual ratios of monetary to nonmonetary items. Other elements which also must be given consideration are the different patterns over the course of time in the acquisition of assets, the incurrance of liabilities, and the raising of capital. There is a feeling that the directors and managers are in a much better position to make required adjustments for the impact of inflation upon their business than the owners or investors who are perhaps far removed from the environment of the enterprise. This would seem to indicate a need for price-level adjusted statements even for the knowledgeable user.[5]

To remain consistent in the rationale that there is a need for adjusted financial statements to provide more reliable financial data for investors, it follows that in evaluating alternative accounting options, the primary criteria should be the income determination method that best reflects the maintenance of the actual physical operating level of the firm. This criteria is deemed superior as it would best reflect maximum potential dividend distribution. There are two basic approaches which may be utilizied in reflecting price changes, general price-level adjustments, and specific or current price-level adjustments. Which method would be preferable is a topic of considerable controversy among the advocates of price-level accounting.[6]

To hope to obtain an understanding of the issues involved and their prospective solutions, it is essential to make the distinction between general and specific price changes. The difference between a resource's historical value and current value is dependent upon two factors. The first of these involves the change in the economy wide purchasing power of the dollar and the second deals with the change in price of a resource because of the individuality of the item.

This point may be illustrated by looking at a simple example. If it is assumed that a tract of land was purchased twenty years ago for $1000 and has a current value of $5000 there has been a realized gain from holding the land of $4000. If during this time the value of the dollar has dropped in general purchasing power to one half the value it was twenty years ago, it is evident it would take twice as many current dollars, or $2000 to purchase the land in terms of general purchasing power. The remaining $3000 increment would be due to the fact the value of the land itself, as a specific item, increased in vlaue at a rate faster than the general price-level.[7]

If adjusted statements are to be forthcoming, a decision must be reached as to which value will provide the necessary information while taking into account the possible adverse outcomes. Would the general price adjustment which would result in the land being valued at $2000 fulfill the needs of the users, or would a clearer picture be presented by valuing the land at $5000, its current value. The arguments favoring each of these proposed methods of adjustments are numerous, and the justifications behind the rationale in both cases have their merits.

Looking specifically at the proposal for the utilization of a general price-level index, the adjustment involved is essentially a restatement of historical cost in terms of the current value of the dollar utilizing the Gross National Product Implicit Price Deflator. This indicator of general price-level is issued quarterly by the Office of Business Economics of the Department of Commerce. In the restatement process, it would be necessary and current value is dependent upon two factors. The first of these involves the change in the economy wide purchasing power of the dollar and the second deals with the change in price of a resource because of the individuality of the item.

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With regard to operating income, the general price-level adjustment will conceptually produce results in terms of dollars of income such that each dollar represents the power to purchase the same amount of goods and services. It is the intention of this adjustment to correct for the overall change in the purchasing power in the economy and not for the change in purchasing power of a specific industry.[9]

Perhaps the strongest single argument for utilizing a general price-level index is the fact that it is merely a restatement of historical cost statements. In this regard, it would not be too severe a departure from existing practice. The accountant would continue to have his essential elements of objectivity and verifiablity under these conditions. Further, the education of the users would be simplified as the relationship between historical cost and the general price-level involves the use of basically one index for conversion of all items.[10]

Price Waterhouse & Co. in a recent editorical cited several items as being superior in the comparison of historical cost statements and general price-level data. These items, which they felt provided more useful supplementary information when based upon general price-level data included:

> 1) Sales trends based on a constant unit of measurement, 2) the impact on income of amortizing nonmonetary items acquired in prior periods at lower price-levels, 3) the effects of fluctuations in the purchasing power of the dollar on the net monetary position of a company, 4) the interaction of interest income (expense) and price-level loss (gain), 5) the real burden of income taxes levied on the basis of historical data, and 6) the effect of dividends.[11]

A further argument for the acceptance of the general price-level index in adjusting historical cost statements is the feeling that the diversity of the corporate ownership group makes the general index a fair average to utilize. The rationale behind this thought is that since ownership of large corporations is geographically dispersed and represents a disperate group with dissimilar expenditure patterns, the use of the general index seems appropriate for use in the computation of income accruing to the typical corporate owner. Although seemingly true, this argument has found very little theoretical support.[12]

Although there are many individuals that favor a price-level adjustment in presenting financial data, there are many that feel that general price-level adjustments alone are not sufficient to properly reflect the results of an enterprise's operations and its financial position. They take the position that the use of a method of value accounting is needed to present a realistic financial picture. Among the more common concepts advocated under a value accounting model, are included the utilization of replacement cost or current cost for asset revaluation.

The replacement cost concept is differentiated from the general price-level or purchasing power concept in that replacement costs deal with the price changes of specific items or groups of homogenous items rather than the overall change in the price of all goods and services. Replacement costs introduces the use of a market price, an appraisal, or a highly specific price index to account for each item in the financial statements.[13]

The current cost concept attempts to present the current value of all resources and obligations at the time of the balance sheet date. As would be expected, these values would differ significantly from the values presented on either the historical cost or the general price-level adjusted statements. Advocates of this highly controversial concept argue that the information to be obtained from current value reporting would be most useful in evaluating an enterprise for investment or management assessment purposes. They further argue that, in as much as most investors have a substantial interest in cash flows of an enterprise, current value data provides the best indicator of the future earnings and cash flows of an enterprise, at least from its present resources. This data, it is contended, will be particularly useful when there is a significant difference between current value and the recorded historical cost of the related assets, which is highlighted during a period of high, rapidly rising inflation.[14]

In the face of pressures for price-level adjusted statements, the advocates for current valuation feel that a general price-level adjustment would not provide reliable information. Strength for this argument can be easily obtained by examining past price-level data. Citing an example utilizing a base of 1967=100.0 for all indexes, the Gross National Product Implicit Price

Deflator used for general price-level adjustments in 1955 was 77.5 and in 1971 was 120.7, indicating a substantial decrease in purchasing power of the dollar generally. In examining specific price changes for certain wholesale price index catagories however, quite the contrary was found to be true. The index for household appliances which was 112.9 in 1955 dropped to 107.2 in 1971, likewise, plastic resins and materials dropped from 126.5 to 88.9, plywood from 120.4 to 114.7, and home electronics equipment from 120.0 to 93.8. As indicated by this example, nonparallel price movements do indeed occur in realistic economic settings. Consequently, the utilization of general price-level adjustment by industries involved in the production of the given products would result in a less reliable figure than the amount reported prior to adjustment. Given this possibility and the objective of cash flow prediction, it is apparant that specific price adjustment would provide users with more reliable information.[15]

Those who advocate the acceptance of a method of adjusting historical cost statements are apparantly basing their arguments on three principle issues, specificialy:

1. The present rate of inflation has a material effect on historical cost financial statements, particularly on the amount of reported income.
2. The utilization of the dollar as a unit of money in statement preparation is not presently reflecting economic reality.
3. The users of financial statements are not in as good a position to make inferences as to the impact of inflation on financial statements as managers are.

The advocate are divided however, on the issue of which method of adjusting historical cost statements would provide the most benefical results. Those who favor the use of a general price-level adjustment base their argument on the fact that such adjustment would not depart severely from present historical cost presentation, the virtues of objectivity and verifiablity would be maintained, and less possible confusion among users would be probable. Those who favor a method of value accounting do so on the presumption that a picture of economic reality would result, with which investors and creditors could make more informed decisions.

Although the arguments presented for adjustment of historical cost statements certainly have their merits, there are also possible drawbacks which may impair their validity. The advocation for the continued use of historical cost statements remains strong, and the arguments against the proposed changes cannot be taken lightly.

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[1] O'Donnell, "Are You Earning What You Think You Are?", p. 55.

[2] Jan Robert Williams, "Differing Opinions on Accounting Objectives," The CPA Journal, v. 43 (August, 1973), p. 652.

[3] Glenn A. Welsch, Charles T. Zlatkovich, and John Arch White, Intermediate Accounting (Homewood, Ill.: Richard D. Irwin, Inc., 1973), p.p. 910, 911.

[4] Glenda E. Ried, "Current Infaltion Requires Another Look At Price-level Accounting," Woman CPA, v. 36 (July, 1974), p. 21.

[5] Louis E. Mullen, "Required Price-level Adjusted Financial Statements: How Soon?", The National Public Accountant, December, 1974, p. 27.

[6] Revsine and Weygandt, "Accounting For Inflation: The Controversy," p. 75.

[7] Philip E. Meyer, "Accounting For Inflation," Massachusetts CPA Review, v. 48 (May-June, 1974), p. 26.

[8] Accounting Principles Board, Statement No. 3., p.p. 713, 714.

[9] Dale Buckmaster and LeRoy D. Brooks, "The Effects of Price-level Changes on Operating Income," CPA Journal, v. 44, (May, 1974), p. 49.

[10] Meyer, "Accounting For Inflation," p. 26.

[11]George C. Watt, "Price-level Reporting in an Inflationary Economy," Editorial, Price Waterhouse & Co. Review, No. 2 (1974), p. 78.

[12]Revsine and Weygandt, "Accounting For Inflation: The Controversy," p. 78.

[13]Ibid., p. 74.

[14]Weston, "Adjust Your Accounting For Inflation," p. 28.

[15]Revsine and Weygandt, "Accounting For Inflation: The Controversy," p.p. 76, 77.

CHAPTER III

Those who are opposed to price-level adjusted statements feel basically that there is a lack of evidence of a really critical need for information different from that which the accounting process already produces. Certainly the lack of interest and the inertia in changing the familiar procedures of processing information also plays a great role in the opposition of price-level adjusted statements. One issue that arises concerns the desirability to replace the time honored historical cost system. This argument involves the contention that traditional accounting methods are uniform, objective, based on verifiable evidence and are widely understood. It is felt by many that these factors along with the principle of conservatism would be impaired with the implementation of a price-level method of financial presentation.[1]

A statement issued to the Trueblood Committee by Ernst & Ernst demonstrates a conservative position in regard to price-level adjusted statements. They stated:

> Accounting data are used for important decisions ... A sudden shift in emphasis, a change in the basis for determining income and for valuing assets, or the adoption of radically different ideas for the presentation of accounting data could cause both consternation and confusion among those who use accounting results and are accustomed to established practice.[2]

Although not entirely opposed to supplying price-level adjusted information, Ernst & Ernst certainly took a cautious approach to its application, giving a great deal of consideration to the use of the data presented and the presently established historical cost statements.

Certainly it is with some justification that public accountants are hesitant about including subjective appraisal values or current replacement costs for fixed assets in the primary financial statements. With the present system utilizing a historical cost basis, the accountant is able to attest to an objective, verifiable report. Likewise users of financial statements, who it is assumed recogonize the weakness in historical cost statements, may apply their own factors in a determination of a current value for a companies plant and equipment.[3]

The Accounting Research Division of the AICPA in a research study published in 1963 classified the objections to price-level adjusted statements into five major groups listed below:

1. Those objections which in effect deny that a problem exists or that it is serious enough to warrant attention.
2. Those objections which admit that a problem exists but deny accounting can handle it.
3. Those objections which admit that a problem exists but fear that the proposed adjustments will have undesirable consequences.
4. Those objections which stress the fact that the proposed adjustments are not yet perfected.
5. Those objections which in effect require the adoption of the proposed adjustments for tax purposes before they are introduced into financial reports.[4]

Although the catagories were established over a decade ago, the arguments are still prevalent today. The seriousness of the problem, the ability of financial reports to solve the problem, the fear of adverse consequences, and the use of unperfected methods of adjustments all remain, to some degree, in the foreground of opposition to price-level financial statement adjustments.

Robert C. Tyson, a member of the project advisory committee which aided the Accounting Research Division in its study of price-level changes, had this comment regarding price-level changes to financial statements:

> Restatement of the balance sheet...may be of doubtful usefulness. Current dollars are not realizable even in liquidation of the company. They represent added costs as they flow through earnings, so that a fantastically increased "equity" value in the balance sheet may indeed be misleading to the enthusiastic investor. For all practical purposes...the main items used in the determination of income are expressed in the current dollars received or spent, with the only exceptions being any effects of inventory valuation and the write-off of depreciation. Why then unduly complicate everything. Let's examine practical means of adjusting for those two cost elements.[5]

Although not completely opposed to price-level adjustments, Mr. Tyson certainly is concerned, as are many accountants today, with the complete restatement of financial statements. The fear that the new position after restatement would be of no beneficial consequence, while at the same time destroying the present acceptable image of historical cost statements, is a position that cannot be taken lightly.

Today, the argument against the use of the general price-level index as proposed for restating financial statements also involves the question of whether or not such a change would provide meaningful insights. Many accountants feel that the restatement of historical costs under the general price-level index proposal would result in a distortion of historical costs sacrificing its presumed virtues as a result. Also, the restated amounts would in fact not be reflective of true current values because the specific price changes would be completely ignored.[6]

One of the major public accounting firms, Price Waterhouse & Co., in taking a position against price-level accounting, quite recently stated:

> Unless inflation is the wild run away type, making historical financial statements meaningless, the need to adjust today's

> dollars to a constant historical basis or historical dollar costs to today's replacement equivalent...is by no means as necessary as some would have us believe. More than that, the aim to eliminate inflationary effects may be seeking an adjustment counter to a fundamental underlying premise of our economy (Inflation).[7]

In a more recent editorial, and in the face of a more rapidly rising rate of inflation, Price Waterhouse qualified their prior position somewhat, recognizing that some selected general price-level information should be disclosed as supplementary information. They did feel however, that the restatement of nonmonetary items in the balance sheet, as would be required in completely restated financial statements, may be interperted as current values and that this possibility might distract attention from the significant general price-level disclosures as previously discussed in Chapter II.[8]

Another argument against general price-level accounting is that the outcome will certainly affect various industries in different manners. General price-level adjustments could improve one industries financial position and at the same time have a deteriorating effect on another.[9] Furthermore, companies in similar industries may be affected differently merely by their physical location. Consider two similar companies during a period of inflation. One is located in an economically depressed area where the condition of other industries in the area has had the result of forcing labor and material rates downward, below the economy wide average. The other is located in a highly competitive area where labor and material rates are considerably higher. Assuming the demand for their products is equal, the use of a general price-level index would result in a reduced income of both firms indicating a loss in purchasing power. In reality, the firm located in the depressed area has actually experienced a gain in purchasing power as the price of the goods and services it has consumed declined in price. Although this is an extreme example, it does lend itself to the fact that general price-level adjustments are certainly not the ultimate answer in accounting for inflation.[10]

One of the basic problems in dealing with current value reporting involves its definition. The theoretical definition of current value is the present value of future net cash flows to be derived from an asset. Utilizing this definition provides problems in that the estimates needed to compute values are subjective. For example, replacement cost, liquidation value, fair market value, and the application of specific price indices to homogeneous assets, all entail, in most instances, some loss of objectivity.[11]

Also considering the theoretical drawbacks involved, Price Waterhouse & Co. rejected current value accounting stating:

> Fair value also has theoretical drawbacks. As a concept, fair value does not stand by itself. One has to ask, "Fair value for what?" Value is determined by prospective use not by adjusted historical cost.[12]

Also from a theoretical view point, it is argued that the problem for current value accounting assumes maintaintance of a firms present operating level. This involves depreciating an asset valued currently with the assumption the firm will replace that asset with an essentially similar asset. A violation of this assumption, such as when a firm purchases substantially improved, superior equipment at a greater cost does little for the support of current value.[13]

From a practical viewpoint, practicing accountants express the feeling that supporters of current value accounting come largely from nonpracticing accountants and not from those who are most deeply involved in the use of financial statement data and realize the difficulties of implementing such a concept.[14] One of the major difficulties in implementing such a concept involves revaluing assets through the use of such subjective tools as insurance values, real estate tax assessments, apprasial values, and the like, not one of which lends itself easily to the concepts of objectivity or verifiablity, upon which a practicing accountant relies heavily.[15]

Opposition to price-level accounting, while recognizing that it does have a pertinent, suggested use for tax accounting and the related flow of investment, point out that the use of historical cost is deeply imbedded in our present law and income tax matters in the United States today. It is generally felt that depreciation under a historical cost system utilized under present tax law does not allow an enterprise to maintain sufficient cash flow to replace assets consumed during a period of inflation. However, the fact that the law is concerned with historical cost leads some to the conclusion that as long as price-level accounting is not acceptable for tax purposes, it is unnecessary to present price-level adjusted statements. Further, it is realized that the effects of inflation are dependent upon the change in the general price-level adjustment for tax purposes could produce a distinct shift in the tax burden from a business, such as a manufacturer composed largely of depreciable assets, to one with large amounts of nondepreciable assets, for example a real estate company. Such a possible inequity would certainly call for large scale reform in the tax structure, which is not presently foreseeable.[16]

Apart from the theoretical aspects of price-level adjustments, but perhaps as equally important in the consideration given their use, is the cost involved in their preparation. The preparation of price-level adjusted statements for a company in the initial year would require considerable time and expense. Although the time and expense required for future years preparation would undoubtly be considerably less, management is never-the-less reluctant to incur these additional troubles and cost to receive statements which give a less favorable picture of the company's financial operations.[17]

A question arises then as to whether or not the benefits derived from price-level adjusted statements will outweigh the costs. Will the massive costs which should be expected to be incurred by a large conglomorate in the initial year of price-level restatement be offset by the potential use of the adjusted statements by its management, creditors, and potential investors in attempting to make better decisions? Or will the presentation of the facts of inflation bring about undesirable consequences adding to the existing confusion in the assessment of its financial reports? Many argue that the advocates of price-level adjustments have not properly weighed the benefits against the costs of restatement. This is particularily true with regard to the larger consolidated industries which present, even under present conditions, highly complex, and in some cases controversial, statements.

Management is also reluctant to adopt a method of accounting which presents a grimmer picture of the company's operation. The use of price-level adjusted financial statements during a period of inflation will usually present a lower net income and, coupled with a greater amount of reported capital, a significantly reduced rate of return on capital. It is further quite obvious that no company would wish to report such adjustments bearing in mind that a company with whom they may be compared is not presenting their financial information in a similar, possibly unfavorable manner.[18]

An additional factor which adds to the opponents strength is the fact that the advocates of price-level accounting are divided on two critical issues. The first issue involves the type of adjustment to use. The question is, which adjustment would provide the most favorable result: replacement costs, realizable values, general price-level adjustments, or some other basis. The type of adjustments proposed by many are opposed by practicing accountants who realize the possible difficulty in convincing management to publish financial statements presenting a less favorable, although perhaps more realistic, picture. Without objective and verifiable amounts, the accountant could find himself in a poor position to attest to managements statements.

The second issue is that the degree to which restatement should be incorporated into the present system of accounting has not been established. Would price-level statements replace present historical cost statements, be an optional substitute, a required supplement, an optional supplement or required only in footnotes describing the impact of inflation on the statements. Prior to implementation of a method of accounting for inflation, these issues must be resolved, placing proponents for price-level adjustments on common ground.[19]

A summarization of the arguments presented by those who favor continuation of the present method of financial reporting include the following issues:

1. There is no real evidence that there is a need for information different than that now presented.
2. The current method is objective and easily verifiable.
3. The proposed changes have unresolved drawbacks which may lead to undesirable consequences.
4. It has not been substantiated that the benefits to be received outwiegh the problems and costs which would be incurred in the implementation of such a change.
5. The adoption of a change could result in widespread confusion among users resulting in a decrease in the reliance on financial statements.

Although these arguments appear valid, the accounting profession and government agencies have given serious consideration to the problem of accounting for inflation, and they appear to be on the brink of implementing a method of accounting which would attempt to at least partially offset the effects of inflation on historical cost financial statements.

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[1]Meyer, "Accounting For Inflation", p. 26.

[2]Williams, "Differing Opinions on Accounting", citing Ernst & Ernst, "An Expression of Views to the AICPA Accounting Objectives Study Group", (1972) p. 10.

[3]Fraedrich, "Inflation and Financial Reporting," p. 21.

[4]Accounting Research Division of the American Institute of Certified Public Accountants. Reporting the Financail Effects of Price-level Changes (New York, N.Y., 1963), p. 44, 45.

[5]Ibid., p.p. 252, 253.

[6]Meyer, "Accounting For Inflation", p. 26.

[7]Williams, "Differing Opinions on Accounting", citing Price Waterhouse & Co., "Price-level Accounting," p. 654.

[8]Watt, "Price-level Reporting in an Inflationary Economy", p. 2.

[9]Buckmaster and Brooks, "The Effects of Price-level Changes on Operating Income", p. 53.

[10]Revsine and Weygandt, "Accounting For Inflation: The Controversy," p. 53.

[11]John Talbott and Robert Holthausen, "Fact Not Fiction - PL(E)AS(E)," The Michigan CPA, v. 26 (July-August, 1974), p. 37.

[12]Williams, "Differing Opinions on Accounting Objectives", citing Price Waterhouse & Co., Current Value Accounting, p. 653.

[13]Revsine and Weygandt, "Account For Inflation: The Controversy", p. 77.

[14]Mullen, "Required Price-level Adjusted Financial Statements: How Soon?", p. 28.

[15]Fraedrich, "Inflation and Financial Reporting", p.p. 21, 22.

[16]Ried, "Current Inflation Requires Another Look At Price-level Accounting", p. 21.

[17] Mullen, "Required Price-level Adjusted Financial Statements: How Soon?", p. 28.

[18] Ibid.

[19] Meyer, "Accounting For Inflation", p. 26.

CHAPTER IV

With expanding pressures calling for a decision involving the need for price-level adjusted statements, the most appropriate method of statement adjustment to utilize, and what type of disclosure is necessary, the accounting profession and related government agencies have not been completely stagnate in their response. In view of all the facts surrounding the objectives and uses of financial data, the American Institute of Certified Public Accountants through the Accounting Principles Board, the American Accounting Association, the Securities and Exchange Commission, and more recently, the Financial Accounting Standards Board have all approached the problem within the last decade.

The problem of accounting for inflation is not new. The Committee on Accounting Procedure of the AICPA addressed itself to the problem in 1948, feeling that although inflation could conceivably cause the dollar costs to lose their practical significance, restatement of assets in terms of the depreciated currency was not necessary at that time. This conclusion took into consideration the fact that the financial statements should possess the capacity of having the maximum amount of usefulness to the greatest number of users, a factor which was deemed present in the statements at that time.[1]

The American Accounting Association in 1966 issued its Statement of Basic Accounting Theory in which it concerned itself with price-level accounting recognizing the fact that heavy reliance is placed upon financial statements by external users and the types of decisions made as a result of such use. The AAA recommended that current cost information as well as historical cost information be reported. This recommendation centered on the criticism of historical cost statements as a basis for prediction of future earnings, solvency, and overall managerial effectiveness. The distinct possibility that management, through use of their influences, introduce bias into the financial statements, presenting as favorable a picture as possible to outsiders was a concern of the AAA. They did feel that these biases could be partially offset by the requirement of current value reporting, particularly if accountants would take responsibility for the measurement methods used in developing the accounting information. Current values, the AAA stated, reflect not only the transactions of the firm but the impact of the environment on the firm beyond the completed transaction-cost concept.[2]

In the late 1960's the AICPA reconsidered the problem of accounting for inflation through the Accounting Principles Board. The consensus reached by the board was released in 1969 when it issued APB statement No. 3, Financial Statements Restated for General Price-level Changes. The board's purpose in issuing the statement was to bring the problem of inflation accounting to the surface and to provide guidance relating to the methods to be used in the adjustment of the historical cost financial statements for inflation.

The recommendations made by the Accounting Principles Board in statement No. 3 involved the use of the Gross National Product Implicit Price Deflator in restating financial statements thus favoring restatement on a general price-level basis. Such restated statements were recommended for presentation as a supplement to the historical cost statements. The board did not feel such statements were necessary for the fair presentation of financial position and operations at that time however, leaving the restatement supplement optional to the statement preparers. The board also discussed general guidelines for the preparation of general price-level adjusted statements involving the appropriate use of the index, classification of monetary and nonmonetary items, presentation of general price-level statements including the gain or loss of purchasing power due to holding monetary items, and the proper disclosure needed for explanation of the adjustments. It was the hope of the board that the techniques presented would be widely accepted so that adjusted data furnished by United States enterprises would be prepared on a consistant basis.[3]

The Accounting Principles Board felt the degree of inflation at the time of the issuance of Statement No. 3 was not of such intensity as to cause conventional historical cost statements to lose their significance. In addressing themselves to the problem however, the Accounting Principles Board chose to overlook two critical areas of concern in accounting for inflation:

1. At what degree of inflation or deflation do general price-level statements become more meaningful to the user than conventional statements, and
2. would it be feasible to present a fairer picture utilizing specific price indices.

From the time of issuance of APB Statement No. 3 until roughly 1973, the topic of accounting for inflation remained in suspension. With the increased rate of inflation, government agencies began to become concerned with the fairness of financial data presented on a historical cost basis.

The Securities and Exchange Commission in 1973 recognized the fact that the rate of inflation had "signicicantly reduced" the usefulness of conventional accounting methods. They further felt that the process of matching costs against revenues was becoming obscured and less likely to produce meaningful information if the costs were incurred at a time when the price-level associated with the receipt of goods and services differed significantly with the price-level when revenues were realized.[4]

Being concerned with the problem of inflation, the SEC in Accounting Series Release No. 151 pointed to two issues which have been raised in the face of ever increasing inflation. The first of these issues involved disclosure of the impact of inventory profits on reported earnings. The second involved the question of whether or not a fundamental change in the basic accounting model used in the preparation of financial statements was needed. Regarding the first issue, the SEC recommended that where 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 of matching older costs with current revenues. The SEC was concerned with the investors being adaquately informed with regard to the source and possible exaggeration of earnings, and believed that users would be better served with disclosure of inflations effect upon current earnings and profits. It is interesting to note that the SEC concerned itself with current replacement cost which involves specific price indices as opposed to utilizing a general price-level index in the adjustments of financial statements. Although the SEC was very strong in its recommendation urging compliance by its registrants, it did not make the proposal mandatory.[5]

The commission felt that the second issue involving a change in the basic accounting model was not appropriate at that time. However, it did point out that the continuation of an accelerated price-level change could bring about such a need. This concept was approached apparently to recognize the need for future consideration of the impact of such a change on all concerned, and to point out that government, management, and the accounting profession must not ignore the present economic conditions that may render present statement presentation methods virutally meaningless. The recommendations made by the SEC through Accounting Series Release No. 151 may certainly be construed as a warning to the accounting profession as to the path it is expected to take prior to the necessity for government regulations to supplement accounting principles.[6]

More recently, a request for comments on price-level accounting by the newly established Financial Accounting Standards Board brought this response from the Accounting Standards Division of the AICPA:

> ...the effects of general price-level changes should be required as information supplemental to the conventional historical dollar financial statements...economic decisions are being...based primarily on intuitive evaluation of the impact of inflation...as supplemental information so that users of financial statements can base their decisions on more realistic measures.[7]

With such a blessing form the AICPA, the Financial Accounting Standards Board was not long in acting on the question of accounting for inflation and issued an exposure draft on December 31, 1974, proposing standards relating to "Financial Reporting in Units of General Purchasing Power". The exposure draft proposed a very significant change in dealing with financial statements: the utilization of a unit of measure in units of general purchasing power rather than units of money. The board recommended the use of the GNP deflator in statement adjustment as did their predecessor, the Accounting Principles Board. Likewise, the FASB defined monetary and nonmonetary items, and recommended recognition of general purchasing power gains and losses realized as a result of holding monetary items during a period of inflation in the determination of net income in terms of general purchasing power. The FASB outlined restatement procedures depicting which items need be adjusted and the tools which are to be utilized in this accomplishment to insure consistancy in presentation.[8]

The boards recommendations are pointed toward supplementary reporting to, as opposed to replacement of, historical cost financial statements. The information which would be required to be reported under the terms of exposure draft include:

> 54. For each period for which an income statement is presented, the following information, at a minimum, shall be presented in units of general purchasing power:
> (a) Total revenue.
> (b) Depreciation of property, plant, and equipment.
> (c) Net general purchasing power gain or loss from holding monetary assets and liabilities.
> (d) Income from continuing operations.
> (e) Net income.
> (f) Net income per common share.
> (g) Cash dividends per common share.
>
> 55. For each date for which a balance sheet is presented, the following information, at a minimum, shall be presented in terms of general purchasing power:
> (a) Inventories.
> (b) Working capital.
> (c) Total property, plant, and equipment, net of accumulated depreciation.
> (d) Total assets.
> (e) Total common stock holders equity.
>
> 56. The presentation of general purchasing power information shall include an explanation of the basis of preparation of the information and what it presents.

Under the terms of the exposure draft, although the above information is required, complete restatement of financial statements for presentation is not required, with footnote disclosure fulfilling the requirement. The required information however, must be obtained from comprehensive restatement of the unit of money financial statements utilizing present accounting principles.[9]

Although the FASB in its exposure draft concerned itself only with general price-level adjustments, it did recognize the need for consideration of specific price-level adjustments. The board made the distinction between general price-level adjustments and current values for the purpose of avoiding a misunderstanding by the statement users. The board responded to an apparent, immediate need for greater financial disclosure involving the effects of inflation by utilization of a general index due largely to the fact that the adjustments utilizing a general index have been quite well developed. The challenge presented by the SEC in considering adoption of current value reporting is apparantly in the minds of the FASB who reserved the option of considering a method of current value accounting, with current value reporting being the topic of a project on the agenda of the FASB.[10]

It is well worth noting that although the consideration given by professional and governmental groups all seem to favor some method of accounting for inflation, their final recommendations are not synonymous. The American Accounting Association and the Securities and Exchange Commission seemed to favor current value adjustments while the Accounting Principles Board and the Financial Accounting Standards have favored a general price-level adjustment, at least temporarily. It appears the draft as presented by the FASB will possibly be accepted, requiring disclosure of general price adjusted data as previously stated. This step however, could be the first in a series of many toward current value reporting.

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[1]Weston, "Adjust Your Accounting For Inflation". p. 25.

[2]American Accounting Association. A Statement of Basic Accounting Theory (Evanston, Ill., 1966), p.p. 19, 28, 29.

[3]Accounting Principles Board. Statement No. 3., p.p. 711, 719.

[4]SEC - "Inflation Impairs Value of Traditional Accounting" (News Report), Journal of Accountancy v. 137 (February, 1974), p. 16, Citing SEC Accounting Series Release No. 151, (January 3, 1974).

[5]Ibid.

[6]Ibid.

[7]"Institute Urges Disclosure of Inflation Impact". (News Report), Journal of Accountancy v. 137 (May, 1974), p. 20, citing Accounting Standards Division of the AICPA (April, 1974).

[8]Financial Accounting Standards Board. (Exposure Draft), Proposed Statement of Financial Standards, Financial Reporting in Units of General Purchasing Power. (Stamford, Conn., December 31, 1974)., p.p. 1-4.

[9]Ibid., p.p. 16-18.

[10]Ibid., p. iii.

CHAPTER V

The initial step taken by the FASB must not be classified as an ultimate solution regarding the question of accounting for the effects of inflation. The fact that a relatively high, gradually increasing rate of inflation has been experienced by many nations throughout the world however, has resulted in a similar step being taken by several of these nations. Accountants have learned that the use of a general index in adjusting historical cost statements, although certainly not without its drawbacks, does a reasonably good job of accounting for inflation, and at the same time maintains the essential features of verifiablity and objectivity.

At what point does inflation make present financial statements meaningless? The SEC and the FASB apparently are of the opinion that an inflation rate of 8% would have a material effect on historical cost financial statements considering their recent publications on the topic. It appears that they feel a form of price-level accounting would be necessary for restatement of present financial statements in such a situation. This rate does not appear to be unrealistic. An extensive study was conducted in Great Britain after implementation of price-level adjustments in statement preparation at a time when the inflation rate was 7%. The study indicated that the rates of returns on stockholders equity averaged less than two-thirds the amount obtained from conventional financial statements, an amount that may certainly be considered material from an investors standpoint.[1]

With such countries as Brazil, Argentina, and Great Britain requiring price-level adjusted data, many other nations look toward the United States to make a similar move. This is possibly due to the advanced accounting structure of the United States, who, along with Great Britain, are perhaps in possession the most highly regarded accounting professions in the world. It could be expected that in the wake of American acceptance, a host of other countries with even greater inflation rates than that of the United States will follow a similar path. The abundance of trade on the world market, the world wide inflation rates, and the present actions of other countries must be taken into consideration in determining whether price-level adjustments should be taken into account in the United States.[2]

Education of users and preparers alike will certainly play a significant role in the implementation of price-level accounting. Possible misconceptions must be detected and disclosed in adjusted statements to avoid such possible results as comparisions of adjusted data with historical cost data and interpretations of general price-level adjustments as a reflection of current value. The currently proposed adjustments should not be too difficult for a sophisticated user to understand, provided proper disclosure is made. In any event, the challenge given to management and the accounting profession with regard to education is enormous.

Although the support for price-level adjustments by businessmen is very important, it is unlikely that corporate management, with its vested interests, will initially favor price-level adjusted statements. It behooves the accounting profession to innovate such procedures to maintain the credibility of financial statements which appear at this time to be diminishing among statement users. Inaction by the accounting profession might very well bring government intervention in the form of SEC requirements which could bring further discredit upon the profession and possible further government intervention in the formation of accounting principles.[3]

Certainly the accounting requirements as outlined by the FASB exposure draft would not bring an end to the controversy over the method of accounting for inflation. Advocation of current value reporting is very much alive and will continue as long as inflation continues at its present rate. If inflation does continue, the acceptance of the FASB requirements might well act as a stepping stone towards the concept of current value disclosure, and could bring about a revolution of the accounting profession. The profession might do well to give the concept serious consideration and act prior to the implementation of government regulations, to insure maintenence of its credibility.

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[1]Mullen, "Required Price-level Adjusted Statements: How Soon?" p.p. 27, 29.

[2]Ibid., p. 27.

[3]Hill, "Accounting has a Credibility Problem--We Must Account for Inflation". p. 57.

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