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Accounting For Inflation

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ACCOUNTING FOR
INFLATION

by

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This independent study submitted by Bruce M. Kinney in partial fulfillment of the requirements for the Degree of Master of Business Administration from the University of North Dakota is hereby approved by the Faculty Advisor under whom the work has been done.

Orville Goulet

Advisor

PERMISSION

Title: ACCOUNTING FOR INFLATION

Department: College of Business and Public Administration

Degree: Master of Business Administration

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Signature Bruce M Kinney

Date September 15, 1981

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ABSTRACT

The purpose of this study is to condense an abundance of technical accounting literature on the problem of inflation in accounting and how to deal with it in the financial reports of business enterprises, in hopes of presenting an important but difficult subject in a manner that investors and students can use when confronted with inflation adjusted statements.

Chapter I presents an overview of the problems that have been created by inflation.

Chapter II provides a discussion of the specific problems of historical-cost accounting in an inflationary environment and the distortive effects it has on financial statements.

Chapter III presents and differentiates the current methods of accounting for inflation, specifically Constant-Dollar and Current-Cost Accounting. The mechanics of each are shown.

Chapter IV submits a background of the Financial Accounting Standards Board (FASB) and Statement No. 33, the Boards authoritative pronouncement on inflation accounting.

Chapter V outlines several arguments in favor of and against inflation accounting.

CHAPTER I

INTRODUCTION

In his new book, Managing in Turbulant Times, Peter Drucker admonishes that during inflation "the figures lie." Drucker argues that the illusion of record profits "leads to the wrong actions, the wrong decisions, the wrong analysis of the business" - in short, "gross mismanagement."

Learning to live with inflation has become a painful experience. The majority of Americans grew up in a world in which prices were comparatively stable for long periods of time and a "sound dollar" was taken for granted. The deepening erosion in purchasing power (PuP) of the dollar in recent years, however, has shaken the confidence of vast numbers of people, in the ability of the U.S. dollar to continue to perform the basic monetary function of serving as a reliable unit of measurement and as a store of value.

One area where the idea of adapting to the reality of inflation has met with rather stiff resistance is in financial accounting. Not that the business world has neglected the issue of recognizing inflation in financial statements- far from it. "We must deal with the cost of inflation in a substantive way, not as if it were a shadow on the financial statement, "says Joseph E. Conner, Chairman of the accounting firm Price Waterhouse & Co.[1] The question of how to present inflation-adjusted financial data has been among the most intensively studied and debated topics in the history of accounting. Most accountants have always recognized the necessity for the formulation of a set of objectives to help in the solution of many accounting controversies. Various practicing and academic individuals have argued ad infinitum about the proper way to account for price level adjustments. In some cases, it was possible that all viewpoints in a discussion were correct, given their stated or implied objectives. Unfortunately, to often the objectives are not stated accurately, and, as a consequence, arguements and misunderstandings continue.[2]

Now thanks to the FASB's new pronouncement on inflation accounting, investors and managers can begin to measure how sharply inflation has sliced into the seemingly handsome but deceptive record sales and earnings for some 1,300 of the nation's largest publicly owned corporations. A study released by Price Waterhouse & Co. analyzez the impact on 157 giant industrial companies in 14 key industries

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[1]"The Profit Illusion," Business Week, 19 March 1980, p. 112.

[2]Revsine and Weygandt, "Accounting for Inflation: The Controversy," The Journal of Accountancy, October 1974, p. 72.

plus 58 other companies in finance, retailing, transportation, and utilities.[3] The results and broad conclusions of that study will be shown in Chapter II.

Perhaps if the forces of inflation should weaken, the pressure for inflation-adjusted financial data will also ease. Few economic forecasters predict much permanent relief from rising prices. Consequently, it is reasonable to expect that inflation-adjusted accounting techniques will gradually be applied to ever-increasing numbers of business enterprises.

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[3]"The Closest Look Yet At Inflation's Corporate Toll," Business Week, 16 June, 1980, p. 148.

TECHNIQUE OF INVESTIGATION

A search of all available pertinent literature from the AFIT, Valdosta State College, University of Georgia, Florida State University, and the literature of the American Institute of Certified Public Accountants (AICPA) was made for this study. Presented are the methods that the Securities and Exchange Commission (SEC) and the FASB enacted to compel large corporations to account for the impact of inflation in their financial disclosures. Primary sources of information were articles and editorials appearing in *The Journal of Accountancy*, *The Accounting Review*, AICPA-accounting research, books, bulletins, and various other periodicals.

CHAPTER II

THE PROBLEM OF INFLATION IN ACCOUNTING

One of the underlying conventions of accounting requires that the data entering into the financial reporting process be expressed in terms of money. Furthermore, in observance of the principle of historical cost, transactions are permanently recorded in the number of units of money actually flowing into or out of the enterprise at the time each transaction occurred. This rule is followed regardless of the changes that may take place in the PuP of money over time. Conventional accounting practices does not recognize the differences in PuP between dollars currently circulated and those that changed hands in the past.

It isn't difficult to see how the differences in the PuP affects the income statement. As items in the balance sheet are used in generating revenue, their monetary values are transferred to the income statement in the process of matching revenues and costs. This process is most easily observed in the case of plant and equipment items- the expired portion of their costs are reflected periodically in the income statement as depreciation expense. It is apparent that the revenues and costs that are matched in the income statement are expressed in terms of different groupings of dollars that have widely different PuP's. Under the rules of conventional accounting, these differences in PuP of different blocks of money are not recognized.

As Joseph E. Connor, Price Waterhouse's chairman, notes:

> As U.S. purchasing power erodes, financial statements that mix dollars of 1965, 1972, 1976, and 1979 are, in effect, commingling four different currencies to measure costs, and those costs are not covered by a dollar of 1979 revenue. Failure to recover costs overstates earnings- both as reported and as taxed. The results are the famous 'obscene' profits- and the infamous unseen taxation of shareholders' capital."[4]

Unbelievable as it seems, General Motors, for all its size, market clout, and financial savvy, earned not one nickel more in constant 1973 dollars in 1979 than it did the five years prior, despite a 20% surge in sales.[5]

Illustrations I, II, III and Table I shows that the corporate profit picture isn't what it appears to be when the numbers are discounted for inflation.

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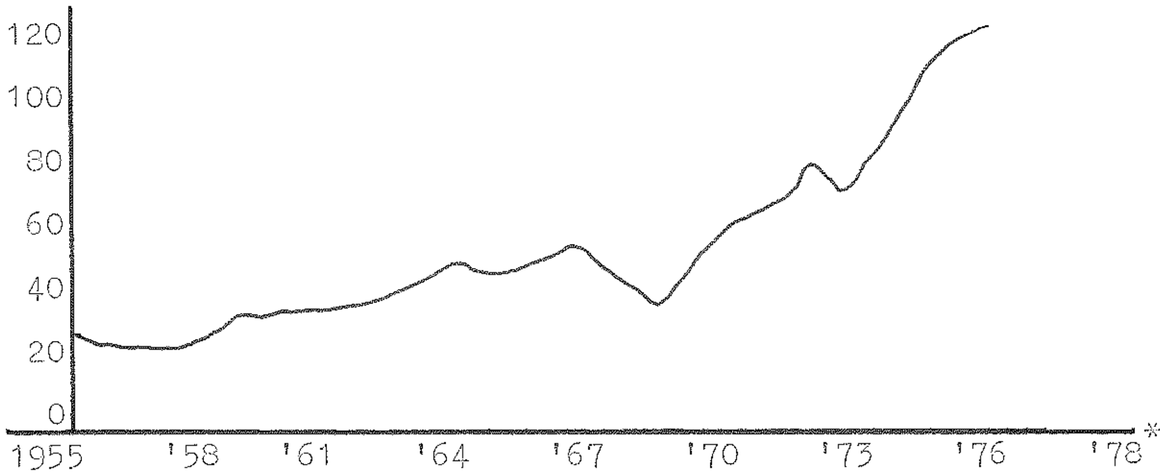
[4]"The Closest Look Yet At Inflation's Corporate Toll," Business Week, 16 June 1980, p. 149.

[5]"The Profit Illusion," Business Week, 19 March 1979, p. 109.

ILLUSTRATION I

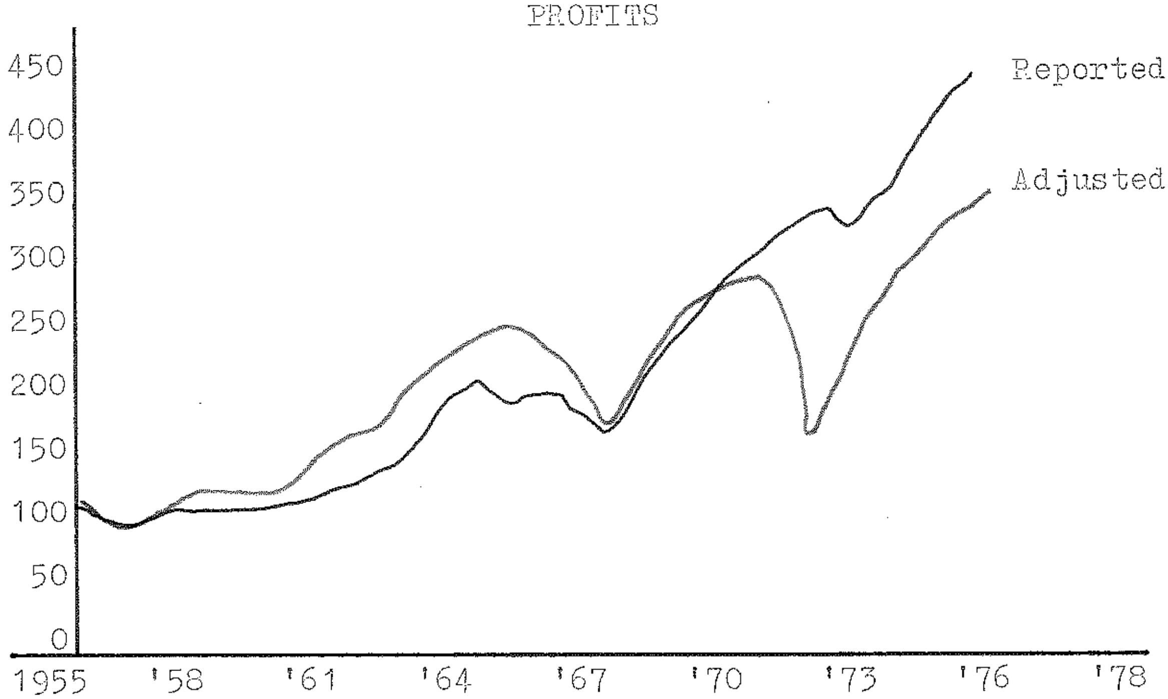
A BOOM IN REPORTED PROFITS



Aftertax profits, Billions of Dollars
*Based on preliminary data
SOURCE: Business Week, 19 March 1979, p. 108.

ILLISTRATION II

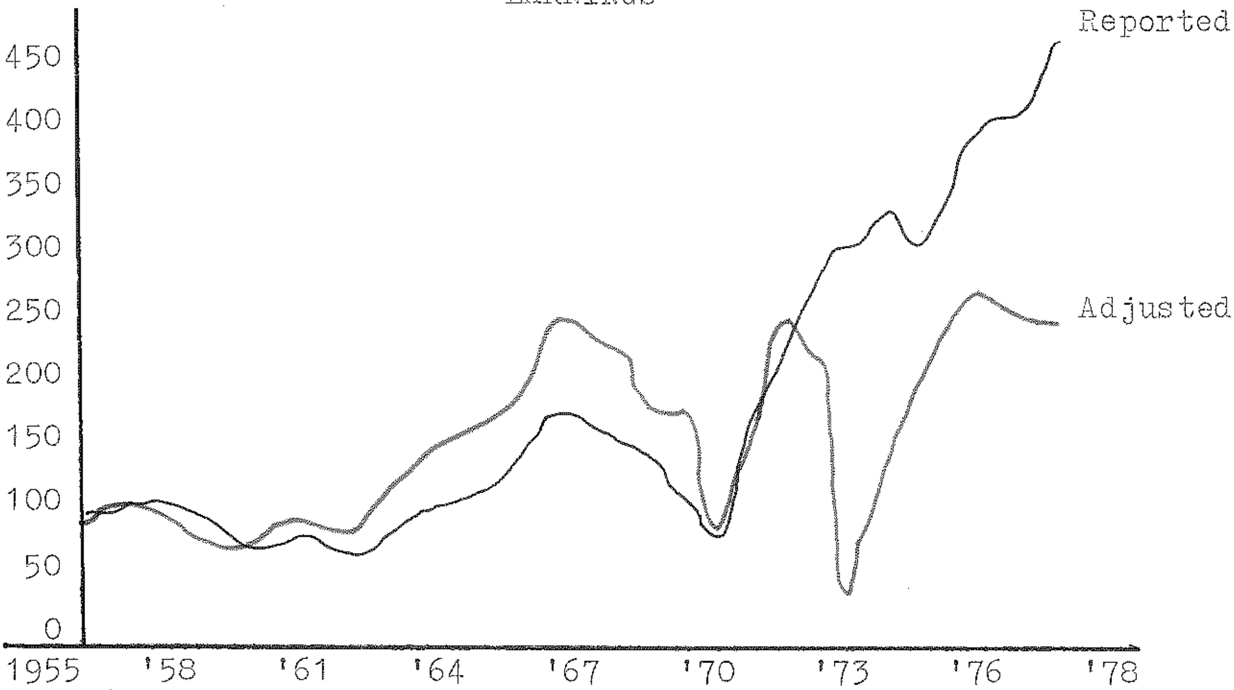
A BOOM IN AFTERTAX
PROFITS



1955=100
SOURCE: Business Week, 19 March 1979, p. 108.

ILLUSTRATION III

A BOOM IN RETAINED EARNINGS



1955=100

SOURCE: Business Week, 19 March 1979, p. 108.

TABLE I

HOW INFLATION CUTS
REPORTED CORPORATE PROFITS

Inflation-adjusted income as percent
of 1979 historical-cost income

INDUSTRY	CONSTANT-DOLLAR METHOD[6]	CURRENT-COST METHOD[7]
Aerospace	78%	70%
Automotive	51	28
Chemicals	62	60
Electrical & Appliance	59	68
Food & Beverage	53	29
Glass & Containers	58	70
Machinery & Equipment	67	61
Metel Mfg	55	51
Office Machinery	42	102
Paper & Forest Products	62	43
Petroleum	62	44
Pharmaceuticals	63	81
Publishing	77	79
Tobacco	55	73
ALL-INDUSTRIAL AVERAGE	60	63
FINANCIAL	95	NR
RETAILING	42	NR
TRANSPORTATION	56	30
UTILITIES	31	17

NR=not reported
SOURCE: Business Week, 16 June 1980, p. 148.

The broad structure of accounting and financial information is based upon the basic objective of providing relevant information to decision-makers. TABLE II reflects the diff-

[6]The Constant-Dollar Method retains historical cost measurements but expresses those measurements in dollars having the same PuP.

[7]The Current-Cost Method replaces historical cost measurements with estimates of the costs that would be incurred to acquire, currently, assets already owned.

erences between historical-cost performance indicators and inflation-adjusted indicators.

TABLE II

INFLATION'S IMPACT ON KEY MEASURES OF FINANCIAL PERFORMANCE

CATEGORY	EFFECTIVE TAX RATE	RETURN ON NET ASSETS	DIVIDEND PAY-OUT RATIO	1975-79 growth in: Sales	Dividends	Stock Price
INDUSTRIAL						
Historical-cost	39%	17%	33%	76%	90%	74%
Constant-dollar	53	8	65	33	41	24
Current-cost	53	8	66	NA	NA	NA
FINANCIAL						
Historical-cost	28	14	32	86	46	69
Constant-dollar	28	13	35	38	12	22
Current-cost	NR	NR	NR	NA	NA	NA
RETAILING						
Historical-cost	42	16	31	112	104	12
Constant-dollar	68	5	299	57	51	-21
Current-cost	NR	NR	NR	NA	NA	NA
TRANSPORTATION						
Historical-cost	30	16	29	99	81	99
Constant-dollar	44	5	42	49	33	42
Current-cost	50	2	72	NA	NA	NA
UTILITIES						
Historical-cost	34	10	76	64	18	-4
Constant-dollar	62	4	543	22	-9	-32
Current-cost	78	2	521	NA	NA	NA

NR=not reported NA=not applicable

DATA: Price Waterhouse & Co.

SOURCE: <u>Business Week</u>, 16 June 1980, p. 149.

TABLES I & II substantiate the conclusions that Price Waterhouse & Co. drew from their study:

1) Inflation-adjusted earnings of most of the business groupings are 40% to 70% lower than the traditional profits reported under historical-cost accounting.

2) Effective tax rates are 15 to 25 percentage points higher with inflation adjustments-often far exceeding the U.S. statutory maximum rate of 46% on corporate income.

3) Return on assets in real terms is only one-third to one-half that under more familiar historical-cost measures.

4) Many industries are paying out twice as much in dividends as commonly thought; for retailers and utilities, dividends exceed inflation-adjusted income, which amounts to paying dividends out of capital.

5) Sales growth during the past four years, after adjusting for inflation, has been less than half as strong as initially calculated. Dividend growth for most groups after adjustment shows even a more pronounced lag.[8]

It may be interesting to note that for 1980 Bethleham Steel, under conventional accounting, had net income of $121 million. But, with inflation accounting, that profit turns into a loss of either $176 million or $257 million, depending on which of the two methods of calculation is used, constant-dollar or current-cost. They also paid dividends of $1.60 a share last year(a total of $69.8 million) on its phantom profits.[9]

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[8]"The Closest Look Yet At Inflation's Corporate Toll," Business Week, 16 June, 1980, p. 148.

[9]"Accounting for Inflation," Time, 13 April, 1981, p.81.

In addition to the distortions created by aggregating dollars of varying PuP, inflation has another economic effect that is not recognized in conventional accounting, that is, holding gains and losses. During inflationary times holders of items such as cash and receivables suffer a real economic loss because the PuP of such assets diminishes with the passage of time. Conversely, a debtor whose obligations are denominated in a fixed number of dollars enjoys a gain because the debts will be repaid with dollars with less PuP than the ones received when the debt was incurred.

Responding to the problems of inflation in accounting began in 1947 with the AICPA's Committee on Accounting Procedures, ARB 43, "Depreciation and High Costs"; they concluded:

> 1) At this time it would not be satisfactory to increase depreciation charges against current income to reflect higher replacement costs of plant or to recognize such costs by recording appraisals.
>
> 2) In considering depreciation in connection with product costs, prices, and business policees, management must take into consideration the likelihood that replacement costs of plant assets then in use would greatly exceed their historical costs.
>
> 3) Periodic appropriations of net income or retained earnings in contemplation of replacement of plant at higher costs was a proper managerial action.[10]

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[10]Glenn A. Welsch, Charles T. Zlatkovich, and John Arch White, Intermediate Accounting, 4th ed., (Homewood, ILL.: Richard D. Irwin, 1976), p.1069.

The Committee on Accounting Procedures was replaced in 1959 by the Accounting Principles Board (APB). In 1963 The APB issued Accounting Research Study No. 6, "Reporting the Effects of Price Level Changes."[11] It was in 1969, after considering reactions to Study No.6, that the APB issued Statement No. 3, "Financial Statements Restated for General Price-Level Changes." The APB concluded that:

> General price-level information is not required at this time for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles (GAAP) in the United States.[12]

The Board recommended that preparation and publication of financial statements restated for general price-level changes as supplemental to the basic historical dollar financial statements, prohibiting presentation of the adjusted statements as the only or basic financial statements.

As part of its guide for preparing general price-level adjusted financial statements, the APB urged that

1) The same accounting principles used in preparing historical dollar financial statements should be used.

2) An index of the general price-level, not an index of the price of a specific type of goods or services, should be used. (GNP Implicit Price Deflator recommended).

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[11] Ibid., p. 1070.

[12] APB Statement No. 3, "Financial Statements Restated for General Price-Level Changes", (New York: AICPA, 1969, p. 12.

3) General price-level financial statements should be presented in terms of the general PuP of the dollar at the latest balance sheet date.[13]

The SEC's Accounting Series Release (ASR) No. 190 was their action to inform investors of the effects of rising prices on the financial statements of corporations. ASR No. 190, issued in 1976, formally mandated disclosure of replacement cost data. The inclusions under the SEC rule are:

1) The current replacement cost of inventories at each fiscal year.

2) The replacement cost of goods sold at the times when the sales were made.

3) The current cost of replacing (new) the productive capacity together with its depreciated replacement cost at each fiscal year end.

4) The depreciation based on current replacement cost of productive capacity, using economic lives, and the straight-line method of depreciation.[14]

In November, 1979, the SEC announced that it had repealed the provisions of ASR No. 190 once the requirements of the FASB became effective. The FASB rules were set forth in the Board's Statement No. 33, "Financial Reporting and Changing Prices," which was released in October, 1979. The requirements of Financial Statement No. 33 (FAS) will be thoroughly discussed in depth in

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[13]Ibid., p. 13-14.

[14]Sidney Davidson, Roman L. Weil, Handbook of Modern Accounting, 2nd ed., (New York: McGraw-Hill Co. 1977). p. 46.

Chapter IV.

Even though both ASR No. 190 and FAS No. 33 are attempts to deal with the same problems of changing prices, the approaches of the two regulatory bodies were quite different. The quantitative results of applying each agency's rules to the same set of financial statements would not necessarily coincide. This paper will attempt to explain why such discrepancies exist.

In closing it should be noted that inflation adjustments and methods of reporting them have been studied for many years. There is no general agreement on how to best present inflation adjusted information to investors. Recognizing the unsettled nature of this aspect of financial reporting, both the FASB and the SEC have gone on record as favoring experimentation and innovation by the preparers of financial statements.

CHAPTER III

APPROACHES TO INFLATION ACCOUNTING

Basically, there are two approaches to the calculation of inflation adjustments. Not only do they differ in their theoretical bases, but they also produce different results when applied to the same set of historical-cost financial records. The two approaches to inflation accounting are (1) Constant-dollar accounting (CDA), and (2) Current-cost accounting (CCA).

Constant Dollar Accounting

The authoritative pronouncement on inflation accounting at the present time is the FASB's Statement No. 33, "Financial Reporting and Changing Prices." This statement defines constant-dollar accounting as:

> A method of reporting financial statement elements in dollars each of which has the same (i.e., constant) general PuP. This method of accounting is often described as accounting in units of general PuP or as accounting in units of current PuP.[15]

The important element in this definition for the purpose of this paper is the concept of reporting in dollars of the same general PuP. CDA differs fundamentally

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[15]Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," September, 1979, FASB of the Financial Accounting Foundation, Stamford, CN.

from the CCA approach in that emphasis on changes in general PuP, rather than on changes in prices of specific commodities or groups of commodities.

Techniques of Constant-Dollar Accounting

Basically, the CDA approach takes the amounts of historical dollars contained in the financial records of a business and applies a general price-level index to these historical dollar balances to restate them in terms of dollars of uniform PuP as of the date of the balance sheet. For example:

Assume you purchased a machine having a historical cost of $10,000 two years ago and the general price-level index was 100. Through inflation, the index has increased 20% to 120. The restated amount to be reported for the asset on the balance sheet is $12,000.

Historical Cost	Index	=	Restated Amount
$10,000	120/100		$12,000

Restatements such as this are calculated for all items in the balance sheet that are classified as "non-monetary," that is, those items whose realizable amounts are not fixed by some kind of contract. "Monetary" items, in contrast, are those balance sheet items whose amounts are fixed by some kind of contractual arrangement.[16] For example, the balance of a checking account at a bank or the

[16] Welsch, Zlatkovich, and White, Intermediate Accounting, p. 1071.

balance of a receivable from a customer are fixed, contractual, monetary amounts that would not rise or fall due to changes in general PuP of the dollar. Nonmonetary items, however, are not fixed and may be restated in terms of changes in the general price-level.

In the methodology of CDA, monetary items are important because they give rise to "holding gains and losses" (Chapter II). These gains and losses are calculated and their aggregate amount is reported as an item in the restated income statements under such captions as "Holding Gain (Loss) on Monetary Items."

A set of restated constant-dollar financial statements, consequently, includes a balance sheet containing a mixed collection of monetary items that are reported in terms of their contractually realizable amounts, and nonmonetary items have been restated in terms of the present-day general PuP of the historical dollars expended or acquired in connection with these items. The restated balance of retained earnings represents the net effects of these restatements.

The income restatement in constant-dollars contains general revenue and expense categories restated in pretty much the same way as indicated for nonmonetary items on the balance sheet. Depreciation expense and cost of goods sold are sharply higher as a result of the restated fixed assets and inventory amounts on the balance sheet, and, the income statement accounts for holding gains or losses on the monetary items.

The Index Problem

One of the points at issue in the case of CDA is the question of what index of general PuP to use for restating the historical amounts. The FASB designated the Consumers Price Index (CPI) for all Urban Consumers, published by the Bureau of labor Statistics of the U.S. Department of Labor, as the index to be used in complying with Statement No. 33. In contrast a decade earlier, the APB recommended the GNP deflator.[17] The AICPA's research study, which preceded the 1969 APB recommendation, contained a detailed treatment of the index number problem.[18] There seems to be fairly general agreement that no price index is completely satisfactory for the purpose of CDA. But, one argument infavor of the CPI is that it is available on a monthly basis.

Pros and Cons of Constant Dollar Accounting

Arguments in favor of the constant-dollar approach to inflation accounting may be summarized as:

1) CDA retains the historical cost principle of accounting; it simply restates the historical dollar in terms of dollars having present-day PuP.

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[17]Welsch, Zlatkovich, and White, Intermediate Accounting, p. 1063.

[18]AICPA, Accounting Research No. 6, "Reporting the Financial Effects of Price-Level Changes,"(New York, 1963), p. 63.

2) CDA measures the distortive effects of inflation and disloses the holding gains and losses arising from monetary assets and liabilities.

The principle arguments against CDA are:

1) Difficulty of finding a suitable index.

2) Complexity and possible confusion on the part of users of financial statements.

3) CDA does not measure the impact of inflation on the specific assets(especially inventories and fixed assets) owned by individual companies.

Current Cost Accounting

FASB Statement No. 33 defines Current Cost Accounting (CCA) as:

> A method of measuring and reporting assets and expenses associated with the use or sale of assets, at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale.[19]

Current-cost accounting, unlike constant-dollar accounting, makes no attempt to retain its tie to historical dollars. The philosophy of CCA is that dollars expended at some point in the past have no relevance in the preparation of a present-day financial statement during an inflationary period. According to this view, the only relevant numbers are the dollars that would be acquired on the balance sheet date. Proponents of this view believe that any other method of valuation is not economically realistic during inflation.

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[19] Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," September, 1979. FASB of the Financial Accounting Foundation, Stamford, CN.

Furthermore, current-cost accounting regards the effects of inflation on an enterprise not in terms of changes in the general price level, as in the case of constant-dollar accounting. Rather, it concentrates on the price level changes of the specific commodities or assets in which the firm is concerned.

The current-cost technique requires the selection of appropriate methods of determining current costs of the items to be measured. FAS No. 33 suggests internally or externally generated price indexes for the class of goods or services being measured; references to current invoice prices; vendors' price lists or other quotations or estimates' and standard manufacturing costs that reflect current costs.

Advantages/Disadvantages of Current-Cost Accounting

The principle arguments in favor of current-cost accounting centers around economic realism. Supporters of this approach to inflation accounting believe that it provides a more realistic measure of the effects of inflation on an individual company because it measures the changes in prices of the specific items with which the company is concerned. They argue that inflation does not affect all firms and all commodities equally and, it is unrealistic to compute inflation adjustments by means of general price indexes.

On the other hand, opponents of current-cost accounting argue that it undermines the objectivity and integrity of financial accounting by abandoning the historical-cost principle. An outgrowth of abandoning historical cost is the difficulty of auditing the estimates of current costs. Finally, the difficulty in finding suitable indexes or other standards of current costs presents obvious problems.

CHAPTER IV

THE FINANCIAL ACCOUNTING STANDARDS BOARD & FAS No. 33

The FASB commenced operations in 1973, and was formally endorsed by the SEC as the official standard-setting body in the private sector in December of that year. The SEC stated that the accounting principles, standards and practices promulgated by the FASB would be considered by the Commission as having substantial authoritative support. The authority of the FASB was clearly outlined in Accounting Series Release No. 150 by the SEC which gave full support to the Board.

The Council of the AICPA also adapted a resolution in 1973 designating the FASB as the body to establish accounting principles subject to RULE 203 of the Institute's rules of professional conduct. According to this rule, Institute members must disclose departures by their clients from FASB standards. Failure to do so is a violation of professional ethics that makes the offender liable to disiplinary action.

The struggle to develope an authoritative pronouncement on inflation accounting came to light in early October, 1979, when the FASB released its Statement No. 33, "Financial Reporting and Changing Prices." The Board declared that the new standard was to take effect for fiscal years ending on or after December 25, 1979. However, permission was given to postpone compliance with one requirement (presentation of current-cost information) until reporting years ending on or after December 31, 1979. Then the inflation-adjusted information would be reported on both bases. FAS No. 33 is an attempt to solve a basic problem with the historical cost accounting model, a problem that can be stated as follows:

> During times of rapidly changing prices, the profits reported in financial statements prepared on a historical cost basis are overstated, and, accordingly, these profits do not represent amounts that investors and creditors can look to in predicting future cash flows. In other words, during times of rapidly changing prices, most, if not all, reported profits must be retained by a business in order to maintain and expand capacity.[20]

This problem is resulting in the "decapitalization" of many company's. According to Sidney Davidson, a professor at the University of Chicago Business School who has written widely about inflation accounting, "... a decapitalization process has begun in many company's and that over a fourth of all major firms are paying dividends

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[20]Ralph T. Bartlett & Thomas H. Kelly, "Will FAS No. 33 Solve Inflation Accounting Problems?", <u>Management Accounting</u>, April 1980, p. 11.

greater than their inflation-adjusted earnings.[21]

FAS No. 33 was the result of work that had gone on at the FASB almost from the time it began to operate in 1973. In 1974, the Board released an exposure draft of a standard on inflation accounting based on the constant-dollar approach. That standard was never adopted because the SEC did not favor constant-dollar accounting. The Commission preferred inflation accounting based on replacement costs and, as described in Chapter II, it set forth its own rules in 1976, requiring replacement-cost disclosures.

As finally issued, FASB Statement No 33 applies to a relatively small number of large corporations. Only those firms with assets totaling more than $1 billion, or whose inventories and property, plant, and equipment (before deducting accumulated depreciation) amount to more than $125 million, are required to make the disclosures specified by the FASB.[22] These size limitations are somewhat comparable to those set by the SEC in 1976 for compliance with its replacement-cost reporting requirement.

The purpose of inflation accounting is, "to provide

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[21] "Living Off Capital", Forbes, November 10, 1980, p.230.

[22] Robert W. Berliner and Dale L. Gerboth, "FASB Statement No. 33, The Great Experiment", The Journal of Accountancy, May 1980, p. 48.

consistent and economically relevant accounting data from which to better measure a company's progress in an inflationary environment."[23] FASB Statement No 33 is one attempt to fulfil that purpose. A complete summary of FAS No. 33 is included in the Appendix of this paper.

A key feature of the FASB's Standard is that the required information is to be disclosed in corporate annual reports to investors in unaudited supplementary form. The basic financial statements (balance sheet, income statement, and statement of changes in financial position) continue to be based on the same conventional, historical-cost principle as before. Many reporting company's are expected to provide their inflation disclosures in the form of notes to the financial statements; although some firms may prefer to highlight their disclosures by giving them greater prominence than a footnot can provide.

There are three principle elements of the required supplementary disclosures:[24]

(1) A statement of income from continuing operations adjusted for changing prices for the current reporting year. This statement must report the major elements of the income statement (a) as given in the primary statements; (b) as adjusted for general inflation (i.e., constant

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[23]William C. Norby, "Accounting for Financial Analysis", Financial Analysts Journal, May/June 1980, p. 17.

[24]Arthur Young & Company, "A Guide To Solving Historical Cost/Constant Dollar Implementation Problems of FAS No. 33, 1979, p. 6.

dollars); and (c) as adjusted for changes in specific prices (current costs). Refer to TABLE III for an example of the income statement of XYZ Corporation that complies with FAS No. 33. Table IV also reflects the impact that compliance with FAS No. 33 had on the income of 15 big companies.

(2) A five-year comparison of selected financial data adjusted to reflect the effects of both general inflation and current costs: (a) income/loss from continuing operations, actual and per common share; (b) net assets at year-end. Also required in this comparison are such data as:

(a) Sales or other operating revenue;
(b) Cash dividends per share of common stock;
(c) Inflationary gain from outstanding debt;
(d) Differences between specific prices and general price level;
(e) Market price per share on common at year-end;
(f) The average consumer price index.

(3) Explanation by management of the significance of these disclosures.[25]

In releasing its new inflation accounting standard, the FASB repeatedly emphasized the tentative and experimential nature of the disclosure requirements. The Board acknowledges that there is much to be learned from the practical application of inflation accounting techniques and it encouraged experimentation and further research. It has declared its intention to monitor the experience developed through this standard, particulary with regard to the usefulness of the data, and will make modifications as experience dictates.

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[25]Arthur Young & Company, "A Guide To Solving Historical Cost/Constant Dollar Implementation Problems of FAS No. 33, 1979, p. 6.

TABLE III

Supplemental Inflation-Adjusted
Income Statement

XYZ Corp.

	Accounting Method		
	Historical Cost	Constant Dollar	Current Cost
Net Sales and Other Operating Revenues	$253,000	$253,000	$253,000
Cost of Goods Sold	187,000	196,569	200,336
Depreciation & Amortization Expense	9,165	14,247	19,842
Other Operating Expenses	30,000	30,000	30,000
Interest Expenses	8,000	8,000	8,000
Provision for Income Taxes	9,000	9,000	9,000
Income (loss) from continuing Operations	$9,000	$(4,816)	$(14,178)
Purchasing Power Gain on Excess Monetary liabilities over monetary assets		$9,302	$ 9,302
Annual increases in current-cost amounts of inventories and plant assets ($36,183), less inflation componet ($25,534)			$10,649

Balance Sheet Data

Inventory	$63,000	$65,000
Plant Assets	$44,000	$96,800

SOURCE: Business Week, 15 October, 1979
P. 71.

TABLE IV

HOW INFLATION AFFECTED 1979 INCOME
OF 15 BIG COMPANIES

Company	Historical Costs	Constant Dollars	Current Costs
	Millions of Dollars		
Alcoa	$504.6	$291.9	$280.1
Armco	221.0	117.5	96.6
Burroughs	305.5	192.8	345.0
Control Data	118.5	1.7	114.7
Dow Chemical	784.0	722.0	696.0
General Electric	1,409.0	1,064.0	986.0
General Motors	2,892.0	1,776.1	1,803.4
B.F. Goodrich	82.6	9.5	.3
Merck	382.0	302.0	340.0
NCR	234.6	119.8	310.7
Singer	(92.3)	(173.3)	(142.5)
Standards Brands	86.4	18.8	21.9
Union Carbide	556.2	394.8	396.3
Uniroyal	(120.5)	(244.2)	(214.7)
Xerox	563.1	344.9	427.5

SOURCE: Business Week, 14 April 1980, p. 116.

Inflation-adjusted accounting is needed in the business environment and without it business believes that their sales are going up when in fact both sales and market shares are going down. They believe that they are making record profits when infact profitability is declining or has disappeared entirely. They believe that they are financially strong when in fact they are on the brink of insolvency and are unable to resist either a credit crunch or a liquidity crisis, both endemic in an inflationary period. Sales, market share, receivables and investment capital, debt service requirements, and profits, all need to be restated continuously in inflation-adjusted figures if businesses are to receive relevant facts.

CHAPTER V

INFLATION ACCOUNTING

PROS & CONS

Opposition to Inflation Accounting

Opponents of inflation accounting declare that attempts to adjust the financial reports of business enterprises so that the distortive effects of changing prices are minimized is so complex and so confusing that the effort is simply not worthwhile. They argue that investors already find conventional annual reports confusing and inflation adjusted data will only make things worse.

Corporate management have generally been unenthusiastic about inflation adjusted financial reporting. The principle reason being that the application of such a change results in a reduction of a firm's reported net income below that which is determined by conventional historical-cost methods. This reduction makes management look bad, and it could impair the amounts available for incentive-compensation purposes.

Other opponents of inflation accounting protest that the objectivity of financial reporting is undermined when any basis other than conventional historical cost is introduced into the measurement process. They object strenuously to the use of current-cost accounting because, it requires the repeated restatment of major financial statement components, such as fixed assets and depreciation. These critics feel that such restatements are based on essentially subjective judgments and that the verifiable benchmark of historical cost is cast aside. They believe that the abandonment of the historical-cost basis seriously reduces the credibility and verifiability of financial reporting. They object to restatment in terms of constant dollars, although not so strenuously, because that measurement approach is at least tied to historical cost. But, they feel that it's a dangerous compromise that impairs the integrity of accounting.

Another school of thought opposes inflation accounting on the grounds of monetary philosophy. Those who hope for the return of sound money believe that giving accounting recognition to changes in price amounts to a final concession that the dollar is, in fact, unstable. Critics who object to inflation adjustments on these grounds argue that inflation accounting aids the forces who they believe, are leading the nation down the primrose path to the ultimate collapse of the dollar and financial ruin.

Arguments in Favor of Inflation Accounting

Supporters of the idea of inflation-adjusted financial reports base their arguments essentially on the principle of economic realism. They believe that the experience of recent years clearly demonstrate the instability of the dollar. Furthermore, they have little confidence that the nation's political leaders and economic policymakers have either the ability or the will to stem the forces of severe inflation. They feel that inflation-adjusted accounting is an absolute necessity if we are to comply with FASB's Statement of Financial Accounting Concepts No. 1, which remarks:

> ... financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions...[26]

Another manifestation of the realism principle is the argument that, to combat inflation, the national economy desperately needs to improve its productivity, and the way to improve productivity is to stimulate capital investment. Supporters of inflation accounting believe that an important incentive to invest in new, improved production facilities would come from reform of the existing depreciation provisions of the federal income tax laws. They argue that the business community needs to demonstrate that it believes capital is being eroded by inadequate depreciation allowances. Business, according to this view, can show its sincerity by reporting depreciation expense to

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[26]Nicholas Dopuch and Shyan Sunder, "FASB's Statement on Objectives and Elements of Financial Accounting: A Review", Accounting Review, Vol LV, No. 1, (January 1980), p.11.

investors based on inflation-adjusted data. The business community cannot claim much credibility in Congress when it asks for more generous depreciation allowances while at the same time reporting high earnings, based on historical-cost depreciation to investors. Consequently, business will never be able to escape the onus of so-called "obscene profits" until it acknowledges that historical-cost based profits are illusory and emphasize instead the realities of inflation-adjusted earnings.

A related argument in favor of inflation adjustments is that board of directors and shareholders both need to be informed of the distortive effects of inflation on the reported net incomes of their corporations. Historical cost-based net income is usually exaggerated, principally because depreciation expense is understated. These inflated earnings create demands from investors for dividend increases that board of directors find hard to resist. Reporting lower net income as a result of applying inflation adjustments would help to relieve such pressures and would have the desirable effect of preserving corporate capital.

In answer to the objection that inflation adjustments undermine the integrity of accounting by moving away from the firm, objectively verifiable base of historical costs, it should be pointed out that constant-dollar accounting in no way abandons historical costs. It simply restates historical dollars in terms of their current PuP through the application of a price index. Even Current-cost adjustments are made in accordance with procedures that are verifiable-such as the application of externally developed price indexes for the class of goods being measured, or determination of direct prices from current vendors' invoices or quotations. The defenders of inflation adjustments point out that recommendations of accounting standard-setting agencies (APB, AICPA, FASB, SEC) have always emphasized that historical-cost financial statements are the primary reports of any enterprise and that inflation-adjusted data are always to be presented as supplementary information.

SUMMARY

Inflation accounting is here to stay. While the present form of inflation-adjusted financial statements may not please everyone, the FASB has labeled Statement No. 33 as "experimental", affording the flexibility to make changes quickly. The necessary concepts and information are at hand to shape the present standard into a form that can be understood by investors willing to spend a bit of extra time studying the new figures and comparing them with historical-based financial statements.

Practically all of the attention that has been focused on inflation accounting during the last two decades has concentrated on external financial reporting. Very little study has been given to the application of these techniques to internal management-reporting systems. Perhaps one reason for this apparent neglect is the assumption that well-informed managers intuitively take inflation into account during the decision-making process. A study into this area merits considerable investigation.

A common business complaint that inflation-adjusted accounting is not useful and is expensive to implement. The vice-president and comptroller of the General Electric Company , Thomas O. Thornson remarked:

Since 1973, G.E. has been using such reports-first, with price-level adjustments and, more recently with current-cost data to help analyze the company's financial results and pricing actions and have found the benefits have more than justified the costs, and the costs, have not proved to be a great burden.[27]

CONCLUSIONS

It is believed that management's written explanation and analysis of the inflation adjusted disclosures will be far more important than the absolute numbers, in answering the question of how inflation has affected the company. Disclosing this information in a manner that can be used by shareholders, employees, creditors and government officials poses a challenging problem. Management would be well advised to insure adequate resourses are devoted to communicating this information even at the expense of some measure of absolute precision in the numbers.

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[27]"Inflation Accounting, Nobody Likes the FASB's New Approach-But What Else Is There", Business Week, 15 October 1979, p. 74.

APPENDIX

STATEMENT OF FINANCIAL
ACCOUNTING STANDARDS No. 33

Financial Reporting and Changing Prices[28]

SUMMARY

This Statement applies to public enterprises that have either (1) inventories and property, plant, and equipment (before deducting accumulated depreciation) amounting to more than $125 million or (2) total assets amounting to more than $1 billion (after deducting accumulated depreciation).

No changes are to be made in the primary financial statements; the information required by the Statement is to be presented as supplementary information in published annual reports.

For fiscal years ended on or after December 25, 1979, enterprises are required to report:

a. Income from continuing operations adjusted for the effects of general inflation.
b. The PuP gain or loss on net monetary items.

For fiscal years ended on or after December 25, 1979, enterprises are also required to report:

a. Income from continuing operations on a current cost basis.

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[28]"Statement of Financial Accounting Standards No. 33, Financial Reporting and Changing Prices," The Journal of Accountancy, December 1979, p. 115.

b. The current cost amounts of inventory and property, plant, and equipment at the end of the fiscal year.
c. Inventory and property, plant, and equipment, net of inflation.

However, information on a current cost basis for fiscal years ended before December 25, 1980 may be presented in the first annual report for a fiscal year ended on or after December 25, 1980.

Enterprises are required to present a five-year summary of selected financial data, including information on income, sales and other operating revenues, net assets, dividends per common share, and market price. In the computation of net assets, only inventory and property, plant, and equipment need to be adjusted for the effects of changing prices.

To present the supplementary information required by this Statement, an enterprise needs to measure the effects of changing prices on inventory, property, plant, and equipment, cost ofgoods sold, and depreciation, depletion, and amortization expenses. No adjustments are required to other revenues, expenses, gains, and losses.

In computations of current cost income, expenses are to be measured at current cost or lower recoverable amount. Current cost measures relate to the asset owned and used by the enterprise and not to the other assets that might be aquired to replace the assets owned. This Statement allows considerable flexibility in choice of sources of information about current costs: An enterprise may use specific price indexes or other evidence of a more direct nature. This Statement also encourages simplifications in computations and other aspects of implementation: in particular, "recoverable amounts" need to be measured only if they are judged to be significantly and permanently lower than current costs; that situation is unlikely to occur very often.

The Board believes that this Statement meets an urgent need for information about the effects of changing prices. If that information is not provided: Resources may be allocated inefficiently; investors' and creditors' understanding of the past performance of an enterprise and their ability to assess future cash flows may be severly limited; and people in government who participate in decisions on economic policy may lack important information about the implication of their decisions. The requirements of the Statement are expected to promote a better understanding by the general public of the problems caused by inflation: Statements by business managers about those problems are unlikely to have sufficient credibility untill financial reports provide quantitative information about the effects of inflation.

Special problems arise in the application of the current cost requirement of this Statement to certain assets, notably natural resources and income-producing real estate. The Board will consider those problems further and address them in an Exposure Draft with a view to publishing a full Statement. This Statement gives guidance on the treatment of those assets and related expenses for enterprises that present current cost information for fiscal years ending December 25, 1980.

This Statement calls for two supplementary income computations, one dealing with the effects of changes in the prices of resources used by the enterprise. The Board believes that both types of information are likely to be useful. Comment letters on the Exposure Draft revealed differences of opinion on the relative usefulness of the two approaches. Many preparers and public accounting firms emphasized the need to deal with the effects of general inflation; users generally preferred information dealing with the effects of specific price changes. The Board believes that further experimentation is required on the usefulness of the two types of information and that experimentation is possible only if both are provided by large enterprises. The Board intends to assess the usefulness of the information called for by this Statement. That assessment will provide a basis for ongoing decisions on whether or not provisions of both types of information should be continued and on whether other requirements in this Statement should be reviewed. The Board will undertake a comprehensive review of this Statement no later than five years after its publication.

The measurement and use of information on changing prices will require a substantial learning process on the part of all concerned. In view of the importance of clear explanations to users of financial reports of the significance of the information, the Board is organizing an advisory group to develope and publish illustrative disclosures that might be appropriate as a guide to preparers in particular industries.

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