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Analysis and Some of The Obstacles to Inflation Accounting

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ANALYSIS AND SOME OF THE OBSTACLES TO INFLATION ACCOUNTING

by

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This independent research report submitted by William W. Kapala 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 Advisor under whom the work has been done.

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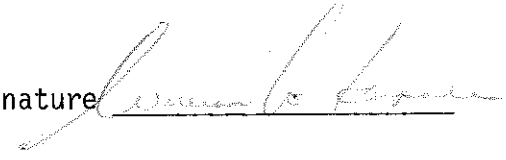
Signature 

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ABSTRACT

The purpose of this study is to peer into the issues and problems of inflationary accounting and provide insight into the obstacles which are generated as a result of any plan to phase an inflationary accounting system into the present historical accounting system.

Chapter I presents a need for a system which can adequately account for fluctuating prices by concentrating primarily on the inadequacies of the historical cost accounting system.

Chapter II provides an interesting discussion of the current cost and value accounting systems in relation to the inflationary accounting options available for use within the two systems.

Chapter III presents several of the key issues involved with any transistion to an inflationary accounting system. Historical cost importance, income and tax reporting, and subjective values are the major issues which are discussed.

Chapter IV differentiates the current cost and value forms of accounting by evaluating the relative advantages and disadvantages of both.

Chapter V attempts to find a common link between the available accounting options and presents a logical argument in support of their simultaneous use in the present system. Current cost is selected over current value for a number of reasons.

Finally, Chapter VI lists several obstacles against an easy transition to the current cost system. The magnitude of these obstacles, however, seems to be well within man's abilities to conquer with time.

CHAPTER I

INFLATIONARY VERSUS HISTORICAL ACCOUNTING

Introduction

Accounting for inflation has been one of the hottest subjects in the United States as well as around the globe over the past decade. Double digit inflation and prospects for continued inflationary trends have added impetus towards the search for an accounting system which will serve these inflationary needs according to accounting objectives. One such fundamental objective is to provide information useful in making economic decisions which are dependent on financial reports. Another is to insure that only relevent, objective, and current events should be recorded on both income and balance statements.

Currently and in the past, the core of financial reports and statements has rested on historical cost data. The continued exclusive use of historical cost methods to represent the financial status of businesses is being questioned at this time.

Historical Cost Deficiencies

Historical accounting is deficient in achieving accounting objectives in many respects. Foremost, historical costing reflects a distorted view of true profits and worth of businesses experiencing

inflationary or deflationary trends. The amount of distortion depends on a number of factors peculiar to each company such as turnover of assets, technological structure, and type of business. In addition, the depreciation of assets in relation to the historical base will not adequately provide for their replacement in later years during inflationary periods. In spite of these apparent anomalies in the present system, there exists much resistance to any system designed to supplant it.

Inflationary Accounting Resistance

First, many experts argue that the longstanding trend of inflation or deflation has not sufficiently been demonstrated to be consistent over the last few years to justify such a drastic change in accounting methods. There are many companies, which for one reason or another, have not been drastically affected by the inflationary trends of the seventies. In fact, costs for some types of businesses actually have declined. Governmental efforts to curb and control inflation have added ammunition to this stand. If inflation can indeed be controlled to a minimum acceptable level, historical costing methods will once again be adequate to serve the needs of business. The reverse would signify admission by government that inflation will continue to be a relentless problem with no bounds in sight.

Secondly, the costs associated with the implementation of any accounting system which will account for inflation will be great. Who should rightfully bear such a cost burden? The government? Individual businesses? Or both? This is obviously a difficult question to answer.

An example points out that this indeed is a viable issue.

The Alan Wood Steel Company recently decided not to comply with the Security Exchange Commission's (SEC) regulation to amend 10K financial statements, which are corporation financial reports, containing information vital to its stockholders. The company's management defended itself in the following assertion:

> The data is irrelevant in light of the company's losses and current financial position, and an expenditure of funds in compliance with the regulation is not considered in the best interest of the company.[1]

All companies are simply not in such a favorable position to assume such a burden. Now the amendment of a 10K report to reflect replacement cost data is just a trivial expense in relation to costs which would be required in a full scale accounting change. Who rightfully should bear such a financial burden is surely an issue which would deserve considerable attention.

Thirdly, business executives cannot be expected to greet any system, which will reduce reportable earnings and relative worth of assets, with great enthusiasm. The ability to maintain current capacity levels can sometimes be dramatically jeopardized during periods of rapid inflation, largely due to insufficient depreciation charges. Resistance to such change is natural for companies which are susceptible to inflationary vicissitudes.

For example, research has been conducted comparing companies on the effect between historical cost and current replacement methods of accounting for income. Some striking characteristics were

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[1]"The Newest Numbers Game," Business Week, June 20, 1977, p. 88.

revealed:

1. Companies with low fixed assets, as in the drug industry, differed very little in profits.

2. Companies with new fixed assets, largely those companies which must be technologically competitive, showed the greatest amount of income under the current replacement cost method.

3. Slower changing technological companies, such as the steel companies, experience great fixed asset coverage and show the greatest difference in reportable profits under the two systems. "Slower" is used to connotate a general inclination of a firm to continue with old technology until obsolescence because of exhorbitant costs of incorporating change, even though changes do occur incessantly within the industry. In fact, most of the larger steel companies show deficits under the current replacement cost method.

4. All companies showed a reduction in profits under the replacement cost method except those with changing technological structures, such as those firms in the computer industry.[2]

Consequently, it is unlikely that companies, especially those in the slower industries, will be extremely receptive to inflationary accounting trends.

Furthermore, the necessity for historical accounting methods will always be present. The maintenance of actual cost records of assets are vital for comparisons over time to be possible, such that decisions

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[2]Ibid., pp. 87-88.

concerning the firm's progress, future price level shifts, and other measurements can be meaningful. Historical costing provides a natural base or standard for this purpose. Hence, the complete abandonment of historical cost methods cannot logically take place.

Arguments for Inflational Accounting

Although there has been considerable discourse concerning various ways to account for inflation, research has only begun to flow in. Examples of inflationary accounting systems in practice in foreign economies, which experience fluctuating and even daily inflationary changes, cannot easily be adopted into the system in existence in the United States. Differences in the existing network of accounting principles and governmental regulations somehow diminish the worth and value of such examples. Proponents of the need to account for inflation are not in unamimous agreement as to the best way to accomplish the task. Forms of current cost and current valued accounting are just some of the more notable methods that are being focussed upon. It is just this issue of what method of accounting for inflation is most equitable and feasible for adaptation into the present accounting structure that is the major theme of this work.

At first glance, incorporation of any system, which will significantly alter the historical accounting system, appears fruitless; however, there exists several sound reasons to hope for the contrary. For one, the need for inflation accounting has never been so great and is likely to increase into the future. To rely on the

assumption that inflation may stabilize to a level, which will allow pure historical methods to suffice, is like kicking a dead horse. The probability is high there will always be fluctuating periods of economic ups and downs over time as substantiated by examples in all advanced nations. It is imperative to the very existence of more stable and healthy economics that prices vacillate relative to the tastes, demands, technologies, operations, as well as business and government policy. To continue a system which will distort the figures is illogical, if not downright obnoxious, in this light.

Many of the companies, which will be driven to extinction as a result of any drastic shift towards inflation accounting, are most likely those companies operating under poor management structures in the first place. There is not sufficient data to pinpoint the types of companies that fall into this category; however, it is logical to assume that these companies have been operating close to their break-even points for some time. At least they cannot be considered healthy on-going firms. They probably have been riding false and glittering hopes of increased company profits for many years.

For example, the Bethlehem Steel Company might easily be tempted to save some $535 million by replacing old plant equipment and thereby take advantage of depreciation changes due to replacement cost calculations under a hypothetical current replacement cost accounting system. Unfortunately, this sum would represent only a return of some 8% on such a large expenditure of funds. Hence, it is estimated that by allowing the company to operate with existing assets as a non-going

concern until liquidation, would increase three-fold the valuation of their present stock value from 32 to 100 dollars per share.[3]

The implication is quite clear; some firms will be severely affected. In contrast, there will be several more companies, which will show increased profits under an inflationary accounting system because of high asset turnover. The reasons could range from an artificially constructed desire to continually improve to that of natural makeup. Companies like Bethlehem may indeed remain prosperous, but not without extensive adjustments. A heavy load will undoubtedly rest upon the shoulders of management to offset the shift in profits. Many companies are not in the fortunate position to possess large net working capital sums or the means to obtain new capital.

On a macro basis the picture of a more true cost of goods and profits will undoubtedly yield a more representative Gross National Product figure. The United States Government is currently toying with the possibility of utilizing two inflationary accounting options, such as current value and replacement cost for depreciation charges in an effort to provide more meaningful financial data.[4]

What seems evident is the need to establish a system, which accounts for inflation without undue delay. Complete abandonment of

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[3]Ibid., p. 88.

[4]"Simon's Plan for Businesslike Bookkeeping," Business Week, November 22, 1976, p. 92.

historical accounting is not advised, for the need to maintain historical records of data and transactions cannot be overemphasized. Management decisions must be based on the assessment of incremental or decremental shifts from the original cost data. Nor can the progress of a firm be effectively measured without the careful analysis of current versus historical data; consequently, no sweeping change from the present system should be advocated, but rather simply a blend of one of the inflation accounting options into the present system.

In fact, that is exactly what is being advocated when the SEC initiates regulations, requiring modification of 10K reports to stcokholders to reflect replacement cost data in addition to the customary historical financial reporting. And in explaining Accounting Series Release (ASR) 190, which is the recent statement that inventories and depreciable assets will be valued at their current replacement cost as well as the cost of goods sold and depreciation charges, the SEC cautions against the misinterpretation of its objectives in application of the rule.[5] Advocation of a wide accounting change is not what is being recommended, but merely the disclosure of more useful and pertinent information concerning the firm.

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[5]Stephen F. Black and Albert A. Koch, "Replacement Cost - Charting the Uncharted Sea," The Journal of Accountancy, November 1976, pp. 72-73.

Chapter II

CURRENT VALUE AND COST FORMS OF ACCOUNTING

Discussion of Available Options

The two most common forms of inflation accounting can be blended more easily into the present system, are current value and current cost accounting. Options such as general price level, current replacement value are merely descriptions of the operators within the two systems. Although each of these are fundamentally similar in that they pose methods of revaluing assets according to a scheme which smooths the irregularities occurring as a result of fluctuations in economic price levels on these assets, they have striking differences. These differences are worth examining.

Direct cost accounting simply is any system which attempts to revalue assets on hand at the end of a reporting period at a value representative of the "true" value of assets either at that time or at the time of their expiration.[6] Current cost accounting would then encompass current replacement, general price level, and current selling price accounting methods. Utilizing the standard

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[6]"True" is defined as near to the real value of the assets with respect to the type of measurement utilized in addition to the standard resource. For simplicity, money is assumed to be the most common form, although other forms, such as general purchasing power, have credibility in regards to their adaptation.

resource of money, the relationship of the three options are emphasized on the balance sheet according to current replacement cost, general price level adjustment, and current selling price respectively. The logical zero point for determing net income or net loss is the point at which owners' equity at the end of the period equals equity at the beginning of the period, excluding transactions with owners.[7]

This view of the current cost accounting options leads one to believe that since the differences can be isolated to the method of revaluing assets in these three ways, the choice of the best option available would be easy at most. Nothing could be more far from the truth. There are several conceptual issues, which manifest themselves when any form of inflation accounting is adopted. These conceptual issues will be addressed in respect to the various options at a later time. But first, an illustration of how historical accounting distorts, along with the implication that current valued accounting offers no guarantee that this distortion can be eliminated, will be provided. Fortunately, any system, which can minimize the affects of distortion, offers a pleasant alternative.

The most common form of current cost accounting in use today is the current replacement cost of assets in evaluating profit. The fundamental rationale in favor of its implementation rests on the conception that conventional reporting of assets during a period of

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[7]Paul Rosenfield, "Current Replacement Value Accounting - A Dead End," The Journal of Accountancy, September 1975, p. 66.

fluctuating prices via the historical accounting approach neglects the provision for continuation of the firm. A hypothetical, but simple example, will aid in bearing this out. This example compares the affects of the historical versus current replacement cost approaches in evaluating assets on operating profit. Replacement cost profits are calculated via the formula, sales revenue less cost of goods necessary to replace those goods or services rendered. A 20% general price level increase has been assumed. (Refer to the illustration on the following page.)

Therefore, the actual amount of company's profits, which can be considered as part of retained earnings under the historical approach is $4500, although its reportable operating profits of the operating year are $7500, as reportable and highlighted to the delight of the stockholders. In contrast, the replacement cost approach yields a much lower reportable operating profit of $6000; yet, this affords a higher amount, which ultimately can be retained by the firm. The difference here actually amounts to the sum:

(1 - Tax Rate) X (Inflation Rate) X (Original Asset Value)

Now, exactly the opposite will occur in favor of this historical approach in deflationary periods where the general price level index drops by 20%.

Calculation of Profit Illustration
(All figures in dollars)

Historical		Current Replacement	
Sales Revenue	30000	Sales Revenue	30000
Historical Cost of Goods	15000	Replacement Cost of Goods	18000
Reportable Profit	15000	Reportable Profit	12000
Tax (Assume 50%)	7500	Tax (Assume 50%)	6000
Profit After Tax	7500	Profit After Tax	6000
Less: Amount to Replace an Equal Amount of Goods	3000	Less: Real Operating Profit	4500
Real Operating Profit	4500	Difference in Tax Payment	1500

Delineation of Related Problems

Of course, this leads one to many important questions in the event of inflation. How should the gains in the cost of goods held during the reportable period be considered? Is the inventory, which increased in value, a holding gain and therefore subject to holding gain evaluation? Is it safe to assume that exactly 20% of the original asset value is accountable via the 20% inflationary increase? This implies that at the beginning of the period. (i.e. that period in which the asset was purchased) the revenue, which was being earned at the beginning of the period, must have been close to the $25000 original sales price for the $15000 asset value or nominal markup value.

In other words, if it is safe to assume that the current replacement cost of similar assets rose by a 20% margin, the same 20% margin must have occurred for prices being charged by the company. Then, why is it not just as correct to expect revenue, earned at the time of sale, to be applied to the cost of goods sold?

All of these questions are very difficult to answer, defend, or refute. Their response demands further evaluation of factors unique to the firm, such as price structure, turnover timing, method of inventory control, economic variables such as those which relate the actual inflationary index to assets rather than a general price index, et cetera. The added significance of the preceding illustration lies in relevation of the multitude of problems which result from the application of any form of accounting change, ever so miniscule.

CHAPTER III

CONCEPTUAL ISSUES

Reducing Importance of Historical Cost

On one side the firm is predisposed to do what is best for its own survival, while on the other, the accountant is obligated to report what is equitable. The bevy of issues, some of which have been touched upon already, must not be overlooked when considering an accounting change.

One issue involves the misconception that the acceptance of any form of accounting change will negate or at least reduce the importance of historical accounting. Basically, there exist two types of possible divisions of operating profit, which is influenced by the current accounting method acceptance: that, which measures the change of asset value held over a period, and that, which substracts current costs from sales over a period. Both of these have been alluded to thus far. In either case, historical costs are not lost. In fact, it is imperative to the very application of inflation accounting to record actual costs as they are vital to the calculation of profit in either case. In certain cases, their significance in the positional statement might be questionable, but their importance in the computation of operating profit and to the decisioning process cannot be overemphasized.

Income and Tax Reporting and Accounting Issues

Another issue is one that concerns any attempt to utilize a general price level index as fundamental in estimating inflationary exactitudes of asset worth over their historical cost. The index is purported to estimate real holding gains and profits during periods of price level shifts; nothing could be further from the truth as exact figures could only result by mere happenstance. Rather, it is specific price level changes per unique and separate assets and holding, which contribute to the real operating income during these periods. Therefore, to accept across the board general price level adjustments must be viewed with skepticism. Furthermore, since current valued accounting rests primarily on the principle that current events must be recorded relevantly and objectively on both the income and balance statements, it is inconceivable any across the board application of a general price level adjustment to historical cost figures will fulfill that requirement.

Reporting of Realized Income

Another conceptual issue concerns the reporting and accounting for realized income over a period. Accounting for holding gains in the current period through current valued adjustments (i.e. through menas such as current selling price, current replacement cost, general price level, or other options) can justifiably be thought of as being reportable in the period in which they occur. On the other hand, they are accountable when they are realized. Once again, subjective value

judgments have to be made, which assert the probability of the firm to realize what has already been reported to have accrued in earlier periods. Obviously, some businesses cannot and probably would prefer not to open themselves to another element of risk.

Taxation Issue

As a logical extension of the preceding issue, one must be concerned with the rightful taxation of accrued or realized income. Should the accrual of income be taxed at the rate that is utilized or during the period that it is realized? Or should it be taxed at the rate commensurated with the period for which it is accrued and applied to the tax liability account? These are moot questions, which have strong arguements from both sides. There exists potentially a further distinction between taxing only money income rather than both real and money income. Yet, how can one justify such taxing arrangements for businesses on real income, while other entities, such as individuals, are taxed exclusively on money incomes? Is this double standard equitable? The effects that any accounting modification will have on taxable income could have dramatic consequences for those entities, which derive their financial support through taxation.

Subjective Issue

The final issue revolves around the importance of subjective values and their ultimate place in current valued accounting. Most

of these value judgments depend on future events or thier expectations. For example, expected rents, interest rates, liability rates, and opportunity cost estimation are just a sample of variables, which depend heavily upon subjective judgments. When one amends historical costs and applies subjective criteria according to the firm's intentions, as is involved in choosing exit versus entry values of an asset or depreciation charges according to whether a machine is capital or labor intensive, he is open to criticism. Concerning this very issue, the Accounting Review Board issued this statement:

> In a business world characterized by uncertainty, it is necessary to recognize that many estimates based on subjective judements must be included in financial statements, and the lack of precision in the data must be found. Investors must understand that due to the subjective judgments and the different specific factual circumstances involved, the data will not be fully comparable among businesses, and thusly will be subject to "errors of estimation".[8]

These issues do not exhaust all of the issues facing the changeover to inflation accounting; however, it represents a credible sample of those issues now facing accounting theorists, politicians, as well as businessmen everywhere. Thus, when one considers the best alternative, one must weigh the effect the alternative makes in relation to these issues as well as the problems it creates perse. Current selling price, replacement cost, and general price level options have innate advantages when they blend into the present system. Each of these options must be evaluated in this respect.

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[8]L. Todd Johnson and Philip W. Bell, "Current Replacement Costs: A Qualified Opinion," The Journal of Accountancy, November 1976, pp. 68-69.

CHAPTER IV

CONTRAST CURRENT VALUE AND COST FORMS

Differentiation of the Two Forms

One major difference, which differentiates current cost from current value accounting lies in the method of determining income. Current cost, regardless of the option that it is based upon, defines income as the increase or decrease in owner's equity at the end versus the beginning of the period. The logical zero point is the point at which owner's equity remains equal. On the other hand, current value accounting defines income as an increase or plus the decrease in the replacement values, in terms of assets held, exclusive of transactions with owners. In addition, net income or net loss is equal to the excess or deficit of realized revenues minus expenses.[9]

The striking difference herein is the non-reliance on income as a function of owner's equity; rather, it is based on replacement "values", which restrict income as a function of owner's equity in terms of operating capacity of the physical assets. Here, the subtlety stems from the definition of replacement "cost" versus "value". Burton defines replacement cost very dissimilar to current value in that value

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[9]Paul Rosenfield, "Current Replacement Value Accounting - A Dead End," The Journal of Accountancy, September 1975, pp. 67-68.

is based on the output of an asset, rather than the inputs necessary to acquire them.[10] In addition, current replacement value accounting recognizes income in the income statement as the changes in assets occur, not when the assets are sold.

As a result, questions concerning dividend payout arise. The first problem arises whenever net assets in terms of the standard resource may actually increase while operating capacity remains level. Consequently, dividends may be paid out legally, which could conceivably change the physical operating capacity of the firm. A solution would entail restrictions on the payment of dividends if and only if the firm can show that operating capacity of the firm can be maintained. The reporting of company's profits should properly reflect what is available for distribution to its shareholders after allowing for such sums as required to keep the business physically intact.[11]

As a possibility, utilizing the notion that some firms may be content to operate with declining rates of returns on the investments, an increase, reportable on the balance sheet, may not be reportable income under this system and controversial. The major purpose of insuring that the operating capacity of a firm is maintained prior to reporting income is based on the assumption that continuity may be

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[10]John C. Burton, "Financial Reporting in an Age of Inflation," The Journal of Accountancy, February 1975, p. 68.

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

maintained in insuing periods.

But by continuity, one must assume the ability to survive. Two subjective points must be shown:

1. The necessary condition for survivability in the long run is to keep the operating capacity level.

2. And prospering can only occur once this survivability condition is confirmed.

History is replete with records of companies, who have failed even though they have increased or maintained their operating capacities. Conversely, many examples exist showing businesses, which have been successful and profitable while decreasing their operating capacities. Depletion of natural resources, while still prospering, provides an obvious example of the latter.

In summary, current replacement value accounting represents a logical system, which attempts to emphasize the economic significance of events transpiring within a business over time. At first glance, it gives an appearance of smoothing some of the anomalies, which arise from reporting assets without regard to their significance into more meaningful income statements. However, this appearance cannot be justified categorically nor can the supporting contention, which implies that progressing begins only after surviving, be considered justification for adoption.

To accept this system is also implying that it is faulty, or at least questionable, to report income as a change in owner's equity

over time, adjusted for the effects of transactions with owners and the effects of inflation or deflation. Certainly, if inflation or deflation existed during a reportable period, this definition seems irrefutable, and furthermore, it is precisely because of this situation that current selling price, current replacement cost, or general price level indexing were devised. (i.e. These options fit unique economic patterns, as well as unique factors within the firm.)

Evaluation of the Pros and Cons of the Two Forms

One of the advantages of current valued accounting lies in its ability to present a more valid image of the true value of a firm. This is generally delightful from the standpoint of a prospering firm's top brass. It is doubly worthwhile from the standpoint of the investor in that it also points out the declining firm as well. The crux of the problem involves the credibility of the figures used in the determination of current values. This can be as expensive as painstaking to the firm.

As was alluded earlier, weak companies cannot afford this luxury, nor the expense to justify misleading figures. For example, one real estate company spent two years compiling information in support of current valued estimations based on current market prices. The values were then adjusted according to forecasts of the following year's expected cash flows, capitalized at an interest rate based on such demographic factors as size, age, risk, and other characteristics. Variables such as competition, market share, and special risk factors

were also weighed. These factors only skimmed the surface of subjective variables. No two accountants or analysists could be expected to arrive at exact figures, unless by pure chance.[12] Extensive regulations, accounting safeguards, and guidelines for reporting accurate and unbiased data would be required. They seem beyond comprehension.

The major thrust underlying current cost accounting is its relative simplicity to apply in that most of the present accounting techniques can be utilized after the adjustments to asset value is computed. The effects this restatement of assets will have on the income statement revolve around changes in depreciation charges and holding gains during inflationary periods. The basis behind cost accounting ideally encourages continued investment in newer assets while insuring the continuity of the firm. In addition, this method provides the opportunity for greater operating efficiencies, thus more than negating the increase in depreciation charges. This aspect is certainly open for challenge. However, replacement accounting does increase the firm's prospects for long term survivability since more capital is retained by the company for asset repurchase in addition to decreasing tax expense, all due to reduced profit reporting during inflational trends.

Current selling price is the current market price at the end

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[12]"Rouse Pioneers More Realistic Numbers," Business Week, October 11, 1976, pp. 124-125.

of the period for the asset. The firm's intentions as to liquidity, expansion, stable growth, or retrenchment will have little or no effect on asset revaluation. However, current selling price suffers by being too specific. The cases that this mode will fit are limited because of the forced assumption, the asset is for sale at today's prices. Changes in assets held in the long run cannot be fairly appraised at current selling prices on goods, which in some cases could be revalued at exit, entry, or replacement values, would introduce distortion in spite of the same. In fact, strict adherence to any particular mode of valuing assets must be viewed with skepticism.

General price level adjustments would seem to alleviate the problem of being specific, in hope that overall averages would tend to negate singular distortions. For example, an asset, which was purchased at a time when the general pricing index was 125 for $5000, would be revalued at the end of the period where the index may have risen to 150 via the formula:

(Historical Value of Asset) X (New Pricing Index/
Original Pricing Index) =
($5000) X (150/125) = $6000

The next step would be to compute the gains and losses that result from the revaluation of assets with their new purchasing power amounts, then compare the financial statements to include the new uniform amounts.

Unfortunately, there are many nonmonetary items, which do not easily render themselves receptive to simple application of this formula. For common stock and retained earnings, variance is not only

a function of price level changes, but many other factors. Although the general price indices may not change over a short run, several factors in the economy may make a nonmonetary asset change value sharply if readily converted to cash. The simple application of the general pricing formula would not do in this case.

Futhermore, there exists some claim that during price index level increases, the depreciation charges will not serve to maintain physical plant or capacity.[13] Since the asset value is being changed according to the general price level index formula, it seems logical to assume the depreciation charge method must be modified in order to maintain pace. A simple, but illustrative example, delineates this point.

Assume a general price level index change occurs for 4 years at such a rate that a 4 year non-salvageable asset, valued originally at $1000, increases by $100 per year in value, such that straight line depreciation techniques yield charges of $275, $300, $325, and $350 respectively for the 4 years. Note, that this amounts to a $150 loss to the firm. Inspection of what actually has happend demands rectification in the following manner.

Since a price level index of 110 for the first year rrvalues the asset at $1100, one must depreciate at the $275 rate, leaving a balance of $825 undepreciated. At the end of the second year the asset value rose by another $100 and therefore, must be depreciated at

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[13] R. J. Chambers, "NOD, COG, and PuPU: See How Inflation Teases," The Journal of Accountancy, September 1975, p. 62.

a new rate pf $308. (i.e. ($825 + $100)/3 years) Continuing in this manner results in depreciation charges of $275, $308, $358.50 and $458.50 respectively for each of the 4 years, totalling $1400. This is exactly what is expected.

Regardless of this modification, general price level suffers largely because of its inherent nature. It is too general.

CHAPTER V

CURRENT COST AS A LOGICAL CHOICE

Common Ground Concerning Options

With all of the arguments against the ocntinuation of historical accounting, one seems assured that any possible response to the problem of establishing an inflationary accounting system would not include maintaining the status quo. But the reason why a system has not supplanted historical cost accounting becomes apparent, once one weighs the differences, issues, and problems related to current cost or value implementation. No one is going to be eager to accept a system which will generate more problems than answers. Consequently, there remains to be considerable support until such time that one accumulates sufficient data, which will diminish the impact from the pitfalls of new accounting acceptance.

Most support for the various plans discussed here stem primarily as a result of wide scale dissatisfaction with the historical accounting system.[14] Little or no change would be a cop out to the challenge ahead in the eyes of the proponents of any inflationary accounting change including one or more of the available options. Most of the offerees of these plans leave us with convincing argu-

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[14] Robert R. Sterling, "A Statement of Basis Accounting Theory: A Review Article," Journal of Accounting Research, Spring 1967, p. 108.

ments in their behalf; yet, the differences are such that there appears to be a plan which can be phased into our system today.

The common ground in which all fo the methods discussed thus far lies in their uniqueness of applicability to certain types of businesses. For example, current selling price would be very applicable for use in businesses, which move countable products, in that the sale transactions could feasibly be recorded and treated separately at reporting time. Retail outlets, which sell numerous products at varying prices, fit the systems using a form of general price level adjustment. Assets being held in the long run would tend to fit replacement cost or value accounting. What becomes paramount is the fact most businesses actually would prefer to adapt several variations of simulataneous applications of the accounting options. No singular plan would do justice in all aspects of their business.

One possible solution would intail classifying businesses within industries according to attributes which correlate to particular accounting techniques and structures. Then, assuming classification was achieved, a suitable accounting method would be required for firms within classes. Unfortunately, this idea runs counter to the observation that differences within companies demand diverse treatment of date. Stereotype fixations in these cases would create distortions of a different breed.

Suitable for Use in Present System

Therefore, it is this writer's intent to favor a more dispersed application of the individual plans discussed. Current valued account-

ing methods should be rejected because they require a significant shift in the accounting philosophy within the United States. It might be conjectured that this is one reason why the SEC did not require amendments for financial data of the larger corporations according to current valued accounting methods, rather than replacement cost accounting. Secondly, current cost accounting offers a plan which can match more easily the system in use today.

The general and conceptual issues will no doubt continue to generate interest. This is a healthy consequence to any form of change. Research and study into the realm of these issues and more will hopefully create a synergistic effect by producing an overall improved system. The issue, for instance, on subjectivity of data will always remain an important issue. The very nature of the revaluing of assets inherently involves expectations of future events. The real catch and challenge is to minimize this subjectivity factor. The dispersed application of accounting methods should achieve this minimization.

A current cost system of accounting, utilizing options such as current replacement cost, current selling price, exit or entry cost, general price level adjustment, or any other appropriately deemed form of asset revaluation, dependent upon the relationship that option has to the asset per se, is what is advised.

CHAPTER VI

SOME OBSTACLES TO IMPLEMENTATION

First, the utmost important objective of coping with fluctuations in the economy will be met head on. The distortion factor, as a result of historical accounting, will be minimized. Although a degree of subjectivity will be inevitable, the amount will be less. The disclosure of information vital to interested parties, such as investors, will be greatly enhanced. All of these advantages hopefully will overshadow the disadvantages until they can be reduced or overcome.

Probably the one most obvious obstacle to this plan is the difficulty of monitoring and auditing the system. The most logical burden of proof, linking a particular mode of asset evaluation to the asset, would lie within the firm or business itself, when audited. In other words, if doubt should arise as to the rationale behind as accounting method's usage, the firm should be in the optimum position to present a cogent argument. For example, a firm, claiming the use of exit value adjustment to assets while preparing for liquidation, probably could not be refuted for its choice. The point is that the firm is in the best position to justify its choice of inflational accounting methods.

The second obstacle follows immediately from the first and concerns different standards that must be used. With diverse and numerous accounting options being used, how does one reply to accusations of

several standards in effect simultaneously? Can one really justify valuing identical assets at different values, simply because of different accounting techniques applied to them according to the whims of management? The answer to these questions must be in the affirmative if one is to support this multi-accounting concept.

In essence, there are several accounting techniques being used simultaneously on sometimes very similar data. That cannot be denied. But these accounting techniques achieve uniform and consistent results; they relate the real asset worth to the firm at reporting time in terms of the standard resource being utilized. If if can be shown that the connection between the option applied and the real worth of the asset to the firm is of a logical nature and substantiated, one can be certain that the ultimate value in context of the standard resource is more representative than a historical figure that purports a meaningless and deceptive measure of asset worth. Maybe it would be apropos to label the standards inclusive as one, real value, or better yet, real worth.

Another disadvantage could stem from the renewed emphasis on company's mores and ethics. But this disadvantage stems from the inclination of people to view businessmen with selfish desires and ultimate distrust. What better way is there to alleviate some of these stereotypes, but to force them into the open? The fact is that implementation of this system would yield disclosures of company information previously held in confidence. Yet, on the opposite side lies the firm, unmoved by any attempt to reveal its intentions, motives and the likes. Laws, concerning the sanctity and revelation of confidential information to author-

ized parties, would have to be devised.

Finally, extensive rules and regulations would be forthcoming, bringing along the problems of education, enforcement, interpretation, to name a few. Education would probably be the single most important task in this respect. Making sure that company officials, executives, accountants, among others understand the definitions, interpretations, procedures, regulations, and guidelines necessary for proper implementation of the plan is imperative. Simulation techniques provide useful and pertinent models and have been widely accepted whenever sophisticated modifications to the accounting system takes place.[15] Models can be designed for use as easy to follow guidelines.

These ideas are not meant to exhaust the possible and orderly steps required for a smooth transistion form the present. Rather they are designed to enlighten the reader to some of the considerations which have to be made. The entire implementation scheme is a basis for a lengthy study itself.

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[15] C. W. Bastable, "Depreciation in an Inflationary Environment," The Journal of Accountancy, August 1976, pp. 58-59.

SUMMARY AND CONCLUSIONS

No other heated issue has existed in the United States in recent years in the area of accounting as the issue of how to properly account for the changing value of assets within businesses. The issue is gaining momentum through each passing day until a system ultimately is put into effect. The system may be entirely different in relation to the apparent and plausible systems that were referred to in this paper. What is significant is that any system, designed to supplant or blend into the present system, must be compared with several logical possibilities. It is gratifying to know that the Security and Exchange Commission and other responsible accounting bodies are not hastily plunging into this task without careful analysis of these alternatives.

It is also hoped that this paper has provided some insight into the problems and issues which will confront the responsible parties, involved in the transistion to an inflation accounting system.

Finally, a seemingly workable soultion to many of the issues has been offered. Although a lengthy study is required to determine the feasibility of the multi-optional concept, its pursuance merits substantial consideration prior to the insistence on a singular inflationary accounting method.

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