8-1978

A Study of General Price-Level Accounting

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A STUDY OF GENERAL PRICE-LEVEL ACCOUNTING

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Bachelor of Science, Northern Michigan University, 1973

An Independent Study

Submitted to the Graduate Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

for the degree of

Master of Science

Grand Forks, North Dakota

August
1978

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CHAPTER I

INTRODUCTION

Accounting Principles Board Statement No. 4 in discussing the principles of financial statement presentation states:[1]

> The presentation principles are more closely related to the objectives of financial accounting and financial statements. The general objectives that deal with the type of information to be provided (for example, reliable information about economic resources and obligations and economic progress) and the qualitative objectives based on characteristics of useful information (such as comparability, completeness, and understandability) directly influence the content of some of the presentation principles.

Financial statements have traditionally been presented in terms of historical cost and measured by monetary units. The interpretability of these statements is based on the assumption that the dollar provides at least a relatively stable unit of measurement. This country has witnessed a steady and significant increase in the level of prices. The stable dollar assumption is no longer tenable. Yet, the presentation of financial statements has not been altered to adjust for these inflationary effects.

General price-level accounting provides a procedure to account for various changes in the general price level. The term "general price-level accounting" is used synonymously with "inflation accounting" and "general purchasing-power accounting."

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[1]American Institute of Certified Public Accountants, Accounting Current Text. Professional Standards volume 3, (Chicago: Commerce Clearing House, Inc., 1977), § 1027.14.

The purpose of this paper is to provide an analysis of general price-level accounting. The basic question is how financial reporting should be altered to reflect changes in price level consistent with the principles of financial statement presentation advanced by the Accounting Principles Board. To achieve the purpose of this paper Chapters III and IV will provide an analysis of the major advantages and criticisms of price-level adjustments respectively. Chapter V is intended to contrast and compare inflation accounting with proposals for current value accounting. The final chapter provides a summary of the project and draws conclusions based on the material presented. First, a brief history of the development and current status of general price-level accounting is presented in the next chapter.

CHAPTER II

HISTORY

The concept of making general price-level adjustments to financial statements is not a recent development. The purpose of this chapter is to present a brief summary of the major historical developments of general price-level accounting.

Henry Sweeney in 1936 published a book entitled Stabilized Accounting in which he proposed the use of an index to adjust traditional statements for inflationary effects.[1] It was not until 1963, however, that the American Institute of Certified Public Accountants published its Accounting Research Study No. 6, "Reporting the Financial Effects of Price-Level Changes."[2] This research effort, which includes a comprehensive investigation, concluded that the GNP deflator could be used as an adequate index in adjusting the traditional financial statements for the effect of price-level changes, and for calculating any gain or loss on holding net monetary items. The study recommended that the price-level information should be disclosed as a supplement to the financial statement presentation and indicated that either providing separate statements or showing the information in

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[1] Henry W. Sweeney, Stabilized Accounting (New York: Harper and Bros., 1936).

[2] American Institute of Certified Public Accountants, "Reporting the Financial Effects of Price-Level Changes," Accounting Research Study No. 6 (New York: AICPA, 1963).

parallel columns would be acceptable.[3]

In 1969 the Accounting Principles Board published APB Statement No. 3, "Financial Statements Restated for General Price-Level Changes"[4] in which they accept the basic concepts of the previously discussed Accounting Research Study. In addition to a theoretical discussion of the subject matter, APB Statement No. 3 provides detailed information on the preparation and presentation of general price-level adjusted statements.[5]

The Financial Accounting Standards Board issued an exposure draft of a proposed statement on December 31, 1974 which if it had gone into effect would have required the presentation of general price-level information. However, the FASB delayed any further action on the project in December 1975.[6]

Consequently, the APB Statement No. 3 is the most authoritative pronouncement on general price-level accounting at this time. The Board suggests that general price-level adjusted statements provide useful information not currently available from traditional statements. Although the Board supported the use of adjusted statements and included a detailed illustration as a guide for the implementation of general price-level accounting, the Board did not require that any action be taken. "The Board believes that general price-level information is not required at

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[3] Ibid.

[4] American Institute of Certified Public Accountants, Accounting Current Text. Professional Standards volume 3, (Chicago: Commerce Clearing House, Inc., 1977), § 1071.

[5] Ibid.

[6] "Statement on Leases, Inflation Delayed," The Journal of Accountancy 141 (January 1976): 12,14.

this time for fair presentation of financial position and results of operations in conformity with generally-accepted accounting principles in the United States."[7]

The recommendations of the AICPA and the APB have had negligible impact on the financial reporting presentations of U.S. firms. Accounting Trends and Techniques in the 1976 issue of the publication's survey of the annual reports of 600 companies found only two firms which presented supplementary information adjusted for changes in the general price level.[8] The 1975 edition of Accounting Trends and Techniques did note that eleven other companies presented information intended to disclose the effect of inflation on the firm's assets and income. However, this data was typically presented in a section of the company's annual report not covered by the auditor's opinion.[9]

Although not included in the Accounting Trends and Techniques survey, the Indiana Telephone Corporation has been reporting price-level information in their financial statements since 1954.[10] The controller of this corporation has indicated that the cost of preparation of these price-level adjusted statements was insignificant beyond the initial year. He further states that the information provided by the price-level adjustments

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[7]AICPA Accounting Current Text, § 1071.25.

[8]Accounting Trends and Techniques AICPA Thirtieth Edition 1976. (New York: AICPA, 1976), pp. 72-75.

[9]Accounting Trends and Techniques AICPA Twenty-ninth Edition 1975. (New York: AICPA, 1975), p. 88.

[10]T. Alan Russell, "An Application of Price Level Accounting," Financial Executive 43 (February 1975): 21.

has been useful in corporate decision making.[11]

The preceding discussion has indicated some of the more significant developments in general price-level accounting. An analysis of this concept will be presented in the succeeding chapters.

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[11] Ibid., p. 78.

CHAPTER III

ADVANTAGES

"Changes in the general purchasing power of money are known as inflation or deflation."[1] The term "general" in the above definition refers to the pervasive effects of the movement of prices for goods and services throughout the economy. As the general price level of the economy rises the purchasing power of the dollar declines. The inflated dollar will then purchase fewer goods and services than it did previously. It is this decrease in the general purchasing power of the monetary unit (in our economy the dollar) that characterizes inflation.[2] Financial statements, which are expressed in units of money, include various items whose value is measured in different periods and consequently in dollars of different purchasing power. Mathematical operations are then applied to these varying units of value. If the measuring unit is not stable, the results of the calculations are likely to be distorted and less useful. The extent of the distortion will depend on the extent of the change in general price level.[3] Even if the annual inflation rates are

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[1]American Institute of Certified Public Accountants, Accounting Current Text. Professional Standards volume 3, (Chicago: Commerce Clearing House, Inc., 1977), § 1071.07.

[2]Robert T. Sprouse, "Understanding Inflation Accounting," The CPA Journal 47 (January 1977): 23-26.

[3]Frank T. Weston, "Adjust Your Accounting For Inflation," Harvard Business Review 53 (January-February 1975): 23.

low enough to appear benign, the cumulative effect may cause material distortions in the financial statements. Financial statements which assume a stable dollar and report items in monetary units ignore the economic realities of inflation.

General price-level accounting is a procedure developed to account for inflation. The purpose of this chapter is to present the major advantages to employing general price-level accounting. General price-level accounting proponents claim that this procedure when applied to traditional financial statements will remove the distorting effects of inflation or deflation. Further, they claim that the price-level adjustments will vastly improve the meaning of income in the statement presentation. The advocates of this approach point out that the application of these general price-level accounting procedures is both practical and objective while its use entails no change in the historical cost concept of generally accepted accounting principles. They also suggest that statements that have been adjusted for changes in the general price level will aid the investor and stockholder in judging the performance of management. Each of these potential advantages will be expanded on throughout the remainder of this chapter.

Removes the Distorting Effects of Inflation

As previously mentioned, general price-level financial statements are designed to account for changes in the general purchasing power of money. This removal of the distorting effects of inflation is a major advantage which proponents of general price-level accounting claim results when the method's

procedures are applied to traditional statements. How is this goal accomplished? The distorting effects of inflation or deflation on traditional financial reports are removed by reporting the items that appear on the statements in units of the same size. By reporting in dollars with the same purchasing power the elasticity from measuring in monetary units is removed.[4]

A basic conversion procedure must be adopted to accomplish the restatement of traditional financial reports to general price-level financial statements. The process involves converting statement items expressed in units of money to items expressed in units of purchasing power. This conversion process is perhaps analogous to foreign currency translation. If a U.S. corporation operates in different countries and reports the results of its operations in mixed currencies, the financial statements will be meaningless. In order to be meaningful to American readers the various currencies, Swiss francs or Mexican pesos for example, must be translated into U.S. currency. The conversion rates may fluctuate or the currency of one economy may steadily increase relative to a weaker economy. In a similar manner, dollars which represent differing purchasing power must be converted to a common unit measuring the same purchasing power before comparisons based on the stated amounts will be meaningful. The greater the fluctuation in general purchasing power from year to year, the less meaningful the combination of these dollars representing varying purchasing power will be.

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[4]Cecilia V. Tierney, "General Purchasing Power Myth," The Journal of Accountancy 144 (September 1977): 92.

The conversion from monetary units to purchasing power units is essentially a straightforward mechanical procedure. Financial statement items are valued in monetary units. These monetary units represent the purchasing power of the dollar amount on the date of the transaction. The objective is to convert the dollar amount into purchasing power units today. An index is required to make this conversion. The index must measure the general price level on the date of the transaction and on the date to which the purchasing power is to be expressed. The conversion is made by multiplying the value stated in the accounts by a fraction whose numerator is the current index and whose denominator is the index at the time of the transaction. The resulting product of this calculation is, then, the historical cost of the item measured in terms of current purchasing power.[5]

For example, suppose that the price index is set at 100 in 19X0 and that the price level rises 25 percent over the next five years. The index in 19X5 would be 125. Assume that 1000 dollars was paid for a machine in 19X0. This dollar amount would be converted to 1250 dollars in 19X5 denoting the 20 percent decline in the purchasing power of the monetary unit. In other words, 1250 19X5 dollars represent the same general purchasing power as did 1000 19X0 dollars.

As previously stated, the financial statements could be reported in terms of general purchasing power by converting the various dollar figures of fluctuating value to a common unit.

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[5] Sidney Davidson, Clyde P. Stickney, and Roman L. Weil, Inflation Accounting (New York: McGraw-Hill, Inc., 1976), pp. 11-18.

In other words, rather than use an elastic unit of money, the amount is converted to a stable unit of general purchasing power. All that is required is a suitable index which accurately reflects changes in the general purchasing power of the dollar from one period to the next. Various indexes are regularly published and may be used; such as the Consumer Price Index or the Wholesale Price Index. "The most comprehensive indicator of the general price level in the United States is the Gross National Product Implicit Price Deflator (GNP Deflator)."[6] The GNP deflator, which is issued quarterly, is the generally recommended index. Criticisms of the GNP deflator and price indexes in general are discussed in chapter four.

The effect of inflation or deflation on money may be viewed from another perspective. The price of various goods and services in an economy are subject to the laws of supply and demand, and consequently the price may vary over time. This price is expressed in units of money. But, the money is really only a substitute for the value of other goods and services for which the dollars may be exchanged. From this perspective, the dollar also may be viewed as a commodity subject to supply and demand. Thus, money may be valued in terms of all the goods and services in general that can be traded for a given amount of it. The GNP price deflator represents an attempt to measure this change in the value of money.[7]

To recapitulate, the adjustment of historical-dollar

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[6]AICPA Accounting Current Text § 1071.09.

[7]Tierney, p. 91.

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[6]AICPA Accounting Current Text § 1071.09.

[7]Tierney, p. 91.

financial statements for changes in the general purchasing power of the dollar results in general price-level financial statements. Proponents of general price-level accounting claim that this process represents a major advantage of the use of general price-level accounting procedures because the adjusted statements present the data with units that are the same size; that is, with units that represent the same amount of general purchasing power. Consequently, proponents claim that the distorting effects of inflation or deflation evidenced in the traditional financial statements have been removed.

Improves the Meaning of Income

A second advantage of general price-level restatements is to improve the meaning of income. This objective is quite closely related to and follows from the first advantage of general price-level accounting; to remove the distorting effects of inflation. However, the measurement of income for a firm has received increasing emphasis from potential investors and financial analysts and, thus, deserves close attention from the accounting profession. The "meaning" of income is improved by a more accurate measurement of the income of the enterprise which would benefit financial statement readers with a more interpretable figure.

The general price-level reports should more accurately reflect the firm's net income if income is assumed to be the increase in the firm's command over goods and services in general.[8]

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[8]Louis E. Mullen, "Are You Ready for Inflation Accounting?" The Journal of Accountancy 139 (June 1975): 95.

One author claims that "...inflation has caused many companies to overstate profits as a result of gains on the inflating value of inventories and understated allowances for depreciation."[9] A firm's calculation of net income is likely to include revenue measured in terms of current or near-current dollars. However, the cost of goods sold and depreciation expensed may be represented by dollars of a bygone era. That is, it is possible that the inventory and plant assets to which these expenses refer are valued in terms of money whose purchasing power was considerably different than the purchasing power of current dollars. The general price-level adjustments should make the accounting calculations more meaningful. Since it is claimed that the dollar figures currently used in financial statements may represent units of varying purchasing power, it is questionable that the sum of measurements taken with this elastic "yardstick" called dollars has any objective meaning. Restating these traditional financial statement figures to a common unit will facilitate any interpretation of the mathematical operations performed on the dollar amounts.

If the firm distributes its net income figure in the form of cash dividends, it is difficult for the individual stockholder to determine if this distribution is really from income or if it is a return of capital. Staubus has indicated that if double-digit inflation should prevail in the economy for an extended period, it is possible that real income of the business sector might be negative, that is a net loss, while nevertheless being

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[9]Richard F. Vancil, "Inflation Accounting - The Great Controversy," Harvard Business Review 54 (March-April 1976): 59.

reported as a normal gain as a consequence of using dollars which have not been adjusted for changes in the general price level.[10] The process could result in the stockholder's misjudgment of a return of capital as income. This could occur when a firm reports a net income figure where the revenue is stated in dollars representing current purchasing power, but due to an inflationary trend, the dollar's purchasing power is much less than its purchasing power in the historical period in which the expenses, deducted from revenue, are stated. In this case, the calculated net income will be larger than the firm's real income (increase in command of goods and services in general) and any return to the stockholders of that amount will include a portion of the stockholders' investment when measured in terms of general purchasing power. An important feature of general price-level statements, then, is to allow the investor to determine if his capital in the business has been impaired by management policies.[11]

A firm's net income as reported on price-level adjusted statements will be affected by any monetary gains or losses it experiences over the period of measurement. An understanding of the concept of monetary gains and losses and the reasons for the inclusion of these items on the general price-level adjusted statements is essential to interpret the price-level adjusted information presented. A discussion of the monetary gain or loss

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[10] George J. Staubus, "The Effects of Price-Level Restatements on Earnings," The Accounting Review 51 (July 1976): 589.

[11] American Institute of Certified Public Accountants, Reporting the Financial Effects of Price-Level Changes, Accounting Research Study No. 6 (New York: AICPA, 1963), p. 15.

concept and its development follows.

The basic procedure for the conversion of traditional financial statements to general price-level adjusted statements has been discussed previously in this chapter. The process simply involves the application of a ratio of index values to the items stated in dollars representing an historical amount of purchasing power to restate the item in terms of current purchasing power units. However, some of the accounts will not need to be adjusted because they are already stated in terms of current purchasing power. Cash, for example, is automatically stated in current dollars and, therefore, requires no price-level adjustment. This type of account is termed "monetary." "A 'monetary' item is one the amount of which is fixed by statute or contract, and is therefore not affected by a change in the price level."[12] Examples of monetary items include cash, receivables, accounts payable, and notes payable.

Any account which is not a monetary item is classified as a "nonmonetary" item. Inventory, prepayments, property plant and equipment, common stock, revenues, and expenses are all non-monetary items. The basic conversion calculation is applied to these items for inclusion in general price-level adjusted financial statements. Note that there is no gain or loss on the revaluation of nonmonetary items. The amount is merely restated with a different measuring unit. This process is conceptually similar to converting a length measured in meters to its equivalent measurement in yards. The length, like the general purchasing

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[12]AICPA Accounting Research Study No. 6, p. 138.

power, remains the same regardless of the particular unit of measurement.

Conversion of a traditional balance sheet to a price-level adjusted balance sheet requires only that the fraction, composed of the current index value in the numerator and the transaction date index value in the denominator, be applied to each of the nonmonetary account balances. If the account balance includes items whose cost was determined at different times, the items in the account must be analyzed and adjusted separately. Monetary accounts are already adjusted to current purchasing power units so no additional calculation is necessary.[13]

The preparation of a price-level adjusted income statement requires essentially the same process. Generally if revenues and expenses can be assumed to occur evenly throughout the year, then these items may be easily converted by multiplying the account balances by the fraction with the year-end index in the numerator and the year's average index in the denominator. If a periodic inventory system is in use, the cost of goods sold figure that appears on the income statement is calculated as a residual and does not represent an account balance. Consequently, the cost of goods sold on the price-level adjusted statement is again calculated as a residual, but a residual of accounts restated to units of current purchasing power. Depreciation and amortization expenses are adjusted in the same manner as their related asset accounts.

When a firm disposes of a fixed asset, the price-level

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[13]Davidson, Stickney, and Weil, pp. 19-35.

adjustments for gains or losses on the sale of these fixed assets require special attention. Note that the gains or losses on this type of transaction should not be confused with purchasing power gains or losses which will be discussed in the next paragraph. A gain or loss on the sale of a fixed asset is noteworthy here because the mere conversion of the dollar amount of the gain or loss to current purchasing power units is not acceptable. That is, this adjustment does not reflect the real gain or loss in purchasing power. Traditionally, a gain from the sale of a fixed asset is recorded as the difference between the proceeds and the book value of the asset. But this book value consists of the cost of the asset in monetary units at the time of purchase less depreciation charges allocated to various periods in which the general price level has shifted. Consequently, the gain must be calculated after the relevant fixed asset items have been adjusted to purchasing power units consistent with the purchasing power represented by the proceeds.[14]

When the general price level shifts during a period, the holder of monetary items will experience a gain or loss. "Holders of monetary assets and liabilities gain or lose general purchasing power during inflation or deflation simply as a result of general price-level changes."[15] For example, if general prices rise during a period the value of the dollar falls and any firm holding cash or receivables will experience a loss since the amount of goods and services that can be bought by the monetary assets

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[14]Ibid., p. 36-54.

[15]AICPA Accounting Current Text, § 1071.18.

declines. On the other hand, holding liabilities fixed in terms of the dollar will produce a gain since the dollars paid to cancel the debt represent less purchasing power than the dollars originally borrowed. The net effect of purchasing power gains and losses due to holding monetary assets and liabilities is explicitly disclosed on a price-level adjusted income statement. Gains and losses resulting from holding monetary assets for working capital needs may be shown separately from those resulting from long-term debt. This additional information may be helpful for the investor to judge management's performance in coping with the effects of inflation.[16]

Accounting Research Study No. 6 states, "If all nonmonetary-account adjustments have been made, the amount required to balance a set of adjusted financial statements will be the net purchasing-power gain or loss on the monetary items."[17] Thus, no independent calculation is necessary to yield the purchasing-power gain or loss figure. Independent calculations usually are made, however, both to act as a check figure and to show the effects of general price-level changes on different account groups.

An independent calculation may be made by the following process. The first step is to adjust the beginning balance of net monetary items to current purchasing-power units. Second, an analysis of changes in monetary assets should be made and the amounts of these changes expressed in units of current purchasing power. This process may be less complicated than it appears.

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[16]Davidson, Stickney, and Weil, p. 44.

[17]AICPA Accounting Research Study No. 6, p. 144.

If revenues are assumed to occur evenly throughout the year, for example, the year's average index may be used as the denominator in the fraction to adjust revenues as a source of monetary items. The results of these two steps should be combined and their sum compared to the net monetary asset figure as stated in the actual accounts at year end. Any difference represents a gain or loss from owing or holding monetary items.[18]

Purchasing power gains and losses are a unique feature of general price-level accounting. The information is not disclosed in the traditional statement presentation. The advantages purported to result from the use of general price-level accounting are due primarily to the disclosure of this information and to the restatement of financial statement items to a common unit; each representing the same amount of purchasing power.

There have been a number of studies which have attempted to show that price-level accounting will in fact have a demonstrable effect on the net income reported by the enterprise. In one such study Buckmaster and Brooks compared operating income as reported on an historical cost basis for forty-two companies with operating income after the statements had been adjusted for general price level and again with operating income prepared on a current value basis.[19] The authors reported the percentage

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[18]AICPA Accounting Current Text, § 1071C.44.

[19]Dale Buckmaster and LeRoy Brooks, "The Effects of Price-Level Changes on Operating Income," The CPA Journal 44 (March 1974): 49-53.

differences between these three accounting models over the eighteen-year period from 1951 through 1969. This study necessitated that a number of complex procedures and assumptions be made in order to make the estimations required by general price-level and current value models. The results of the study were in agreement with the authors' hypotheses. The incomes under the current value and the general price-level models were consistently lower than the historical cost data. The study suggests that in a period of inflation the historical financial statements tend to overstate income. The average overstatement was by approximately 18 percent. The study further revealed operating income obtained from price-level adjustments and that obtained employing a current value model varied between industries and between companies within an industry. The authors considered the differences found between the three procedures for an individual firm to be material.

In a similar study, Gittes compared net incomes obtained from general price-level adjusted data and from the historical cost data prepared according to generally accepted accounting principles for four companies in the steel industry; two of the companies in the sample were giants in the industry while the other two were smaller firms.[20] The results obtained from Gittes' adjustments differed from those found by Buckmaster and Brooks. For all four of the steel companies analyzed the general price-level adjusted data resulted in a higher net income than reported

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[20]David L. Gittes, "GPL Adjusted Income Statements: A Research Study," Management Accounting 59 (October 1977): 29-33.

on the firms' traditional statements. In addition the ranking of the firms according to their net income shifted slightly with the price-level adjustments. The author concluded that the most critical items on the price-level adjusted data were gains from monetary items which more than offset the increased depreciation charges which resulted from the cumulative effect of price-level changes occurring over the life of the fixed assets. A potential weakness in both of these studies exists in insuring the adjustment accuracy for the many estimates that their procedures required.

Paul Rosenfield conducted a study authorized by the American Institute of Certified Public Accountants' Accounting Principles Board in which the participating firms computed the price-level adjustments using their own accounting records.[21] This alleviated the difficulty encountered by many researchers in obtaining the needed information. Eighteen companies representing varying industries participated in this experiment. The adjustments were made using the Gross National Product Implicit Price Deflator as the measurement of price-level changes. (The GNP deflator appears to be the index generally used in inflation studies.) The results of this comprehensive experiment proved complex without notable generalizations. The adjustments did seem to particularly affect intercompany comparisons. Reported differences varied from four percent to thirty-one percent with some companies reporting an overstatement of income and others an understatement of net income when the general price-level changes

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[21]Paul Rosenfield, "Accounting For Inflation - A Field Test," The Journal of Accountancy 127 (June 1969): 45-50.

are ignored. The adjustments tended to affect capital-intensive companies more than others. Rosenfield suggests that some of the most significant restatements resulted from the following factors: large inventories stated at FIFO cost, depreciation charges related to assets which had been purchased years before, and general price-level gains and losses from the firm's composition of monetary items. Interestingly, "twice as many companies had general price-level gains as had losses."[22] Taken as a whole the results of the three studies presented suggest that price-level adjustments will provide differential information concerning the financial position and results of operations of business enterprises and information that may be material in nature which is not disclosed in the traditional statement presentation.

Provides Practical and Objective Procedures

In the previous sections of this chapter the computational process for adjusting traditional financial statements to account for inflation was presented. Since the conversion process is completely mechanical, proponents claim that performing the price-level adjustments is both practical and objective.[23] Savoie has suggested that the objectivity in application of these procedures is quite appealing to the accountant. Because the same index could be used by all firms (the GNP deflator for example), the results could be audited.[24] The procedures do not require

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[22] Ibid., p. 49.

[23] Mullen, pp. 91-95.

[24] Leonard M. Savoie, "Price Level Accounting, Practical Politics, and Tax Relief," Management Accounting 58 (January 1977): 17.

extensive estimates and appraisals. The objectivity evidenced in the historical cost principle continues with general price-level adjustments. The basis for the valuation does not change. "The restatement would merely convert historical cost now measured in terms of numbers of dollars to historical cost measured in terms of units of general purchasing power."[25]

Enhances the Individual's Ability to Judge Management's Performance

The Accounting Principles Board in APB Statement No. 3 claimed that these general price-level reports "should prove useful to investors, creditors, and others who are concerned with the economic affairs of business enterprises."[26] An important feature of general price-level statements is to allow the investor to determine if his capital in the business has been impaired by management policies.[27] A fourth expected advantage to general price-level accounting is to enhance the investor's ability to evaluate management.

Price-level adjusted financial statements should facilitate inter-period comparisons. For example, suppose that a firm's net income has increased 40 percent over the last decade. This performance may appear attractive indeed, but suppose that over the same period prices have increased 50 percent. A whole new perspective of that company's performance is gained by this additional information.[28]

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[25]Sprouse, p. 24.

[26]AICPA Accounting Current Text, § 1071.06.

[27]AICPA Accounting Research Study No. 6, p. 15.

[28]Davidson, Stickney, and Weil, p. 5.

Price-level adjusted statements should facilitate inter-firm as well as inter-period comparisons. Inflation does not affect all firms equally, and some firms have coped with its effects better than have others. Nor does inflation have the same impact on all industries. Because general price-level accounting removes inflation-caused distortions, the price-level adjusted statements allow the investor to more easily make these discriminations.[29]

These observations are supported by an empirical study conducted by James Parker.[30] He applied the general price-level accounting techniques with the aid of computer programs which he had developed to the reported statements of 1050 firms. The resulting data was expected to approximate the results these firms would have reported had they provided price-level adjusted data. The author noted that the impact of these adjustments varied widely. On the one hand the 161 utility and transportation firms would have doubled their reported net incomes had they made general price-level adjustments. On the other hand, "seventy-two firms had historical profits restated into price-level adjusted losses."[31] Parker concludes that price-level adjusted information would be valuable to investors who make decisions relying on inter-firm comparisons since there was a great deal of variation among the firms and industries studied.

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[29]Tierney, p. 91.

[30]James E. Parker, "Impact of Price-Level Accounting," The Accounting Review 52 (January 1977) 69-95.

[31]Ibid., p. 59.

This chapter was intended to provide a presentation of the major advantages to general price-level accounting advanced by proponents of this approach. The next chapter will consider these proposals from a more critical perspective.

CHAPTER IV

CRITICISMS

In the previous chapter, the major advantages for adjusting financial statements to account for changes in the general price level were presented. The presentation did not attempt to evaluate the relative merits of these arguments. The purpose of this chapter is to consider the central criticisms which have been levied against general price-level accounting. Opponents of general price-level accounting have criticized the accuracy of the compilation of the price-level indexes necessary to make the price-level computations. Some opponents have criticized the concept and calculation of general price-level gains and losses which are a unique feature of the general price-level adjusted income statement. The usefulness of the information provided by general price-level adjustments has been seriously questioned. Further, some authors have expressed concern that the presentation of financial statements that have been adjusted for changes in the general price level will confuse rather than enlighten financial statement readers. In the remainder of this chapter each of these criticisms will be more fully discussed.

Price Indexes

Adjustments are made to the traditional financial statements by the application of a ratio composed of the relevant price indexes. A more thorough explanation of this process was presented

in chapter III. The interpretability of the result of the general price-level adjustments is to a large degree dependent on the ability of the price index to measure the rate of price change within the economy. To remove the distortions extant in financial statements introduced by inflation, it is first necessary to develop a measure to provide price-level change information. Price indexes are designed to accomplish this goal.

A major criticism of general price-level accounting attacks the general accuracy of the published indexes. The GNP deflator has been criticized as not being sufficiently reliable for use in accounting reports.[1] Stickney and Green have pointed out several deficiencies in the reliability of general price indexes.[2] These authors indicated that price-level indexes are compiled by determining the quoted prices from sellers rather than actual transaction prices. Maintaining a constant "market basket" to measure price changes over time omits the impact of new products developed which are substitutes for products included in the survey. There is the problem that the items covered will be outdated and consequently not measure current consumption. In addition, in measuring items currently purchased, it is difficult to adjust for shifts which are due to quality improvements or to product purchase shifts prompted by price increases. Either of these buying patterns may cause the fixed weights to become obsolete. The weights are based on the relative expenditures for

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[1]Morton Backer, Current Value Accounting (New York: Financial Executives Research Foundation, 1973), pp. 144-146.

[2]Clyde P. Stickney and David O. Green, "No Price-Level Adjusted Statements, Please (Pleas)," The CPA Journal 44 (January 1974): 25-30.

the items covered by the index at the beginning of compilation. In order to measure price change for a consistent set of items the weights are not often adjusted. Changes in quality, buyer preference and even productivity may be expected occurrences in a dynamic economy. Nevertheless, the price index may not be sensitive to these changes.[3]

Much of the criticism expressed by Stickney and Green appeared to be directed toward the Consumer Price Index. Backer, in his text Current Value Accounting, explicitly criticizes the GNP Implicit Price Deflator Index.[4] The GNP deflator does not measure the price change for a specific quantity of goods. Rather it is intended to measure the more pervasive aspects of price-level changes in the economy. This index has nevertheless been criticized for ignoring changes in productivity and its inability to filter out the impact of technological improvements. The author suggests that the cost of living has increased in part due to a higher standard of living concommitant with shifting consumer tastes. Backer notes that the AICPA Research Division cautioned the use of price indexes in comparisons over a long period of time stating, "This means that an index should not be used for projections too far back in the past."[5] Yet, a significant aspect of general price-level accounting is the adjustment of dollars representing the acquisition cost of fixed assets and the related increased depreciation charges on the price-level adjusted income statement.

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[3] Ibid., pp. 28-30.

[4] Backer, pp. 144-146.

[5] American Institute of Certified Public Accountants, Reporting the Financial Effects of Price-Level Changes, Accounting Research Study No. 6 (New York: AICPA, 1963), p. 50.

Backer further points out that although the GNP deflator and the Consumer Price Index both measure general price-level changes, these indicators do not necessarily change at the same rate.[6]

Proponents of general price-level accounting would accept the assertion that the price indexes are imperfect devices. The unresolved problem is whether the price-level change indicators are sufficiently reliable to provide useful information to financial statement readers.

Price-Level Gains and Losses

The inclusion of price-level gains and losses on the financial statements is a controversial issue in general price-level accounting. An individual entity which holds money as the general level of prices rises will sustain a loss in general purchasing power; that is, a given amount of currency will buy decreasing quantities of goods in general. Gains or losses in purchasing power due to owing or holding money are disclosed in price-level adjusted income statements.[7] The calculation of purchasing power gains and losses requires that financial accounts be characterized as monetary or nonmonetary. Only changes in net monetary items result in the price level gains or losses. "The essential characteristic of an asset classified as monetary for general price-level accounting is that its holder gains or loses

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[6]Backer, p. 145.

[7]American Institute of Certified Public Accountants, Accounting Current Text. Professional Standards volume 3, (Chicago: Commerce Clearing House, Inc., 1977), § 1071.17.

general purchasing power during inflation or deflation simply as a result of general price-level changes."[8] "Monetary" assets and liabilities are those items whose "amounts are fixed by contract or otherwise in terms of numbers of dollars regardless of changes in specific prices or in the general price level."[9] The application of this definition may be difficult in practice. One author has suggested that the distinction between monetary and nonmonetary items is arbitrary. He points out that such items as deferred income, convertible debt, and foreign currency are particularly troublesome.[10] Convertible debt, for example, may be viewed as either a monetary or a nonmonetary item. Since the amount of the debt is fixed by contract in terms of dollars it may be classified as "monetary." On the other hand, the instrument may be converted to capital stock; a "nonmonetary" feature.[11] That is, no gains or losses in purchasing power are incurred simply as a result of general price-level changes. Foreign currency is distinguished from the currency in which the financial statements are presented in that the translation rate of exchange may vary independently of changes in the general price level. Thus foreign currency is generally classified as a "non-monetary" asset.[12] Another problem associated with reporting

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[8]Loyd C. Heath, "Distinguishing Between Monetary and Non-Monetary Assets and Liabilities in General Price-Level Accounting," The Accounting Review 47 (July 1972): 464.

[9]AICPA Accounting Current Text, § 1071.18.

[10]Eldon S. Hendriksen, Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1977), pp. 230-2.

[11]Ibid.

[12]AICPA Accounting Current Text, § 1071.21.

purchasing-power gains and losses on price-level adjusted financial statements is when to recognize the gains as income.[13] The realization principle of accounting generally requires that gains be earned before they are recognized in the accounts. However, since purchasing power gains are not related to a subsequent event or transaction, they are generally recognized in the period of price-level change.[14]

A more fundamental criticism is directed toward the interpretability of price-level gains and losses. For example, the price-level loss related to holding a monetary receivable may be incorrectly interpreted as a disadvantage of holding the instrument if the firm had accurately anticipated the inflation and adjusted the interest rates demanded accordingly.[15] Kaplan questions whether any price-level gain should be reported for a firm with significant long-term debt if the effects of inflation have been correctly anticipated.[16]

Confusion with Current Value

Since general price-level accounting requires that the traditional financial statement be adjusted to reflect the impact of inflation, some statement readers may be mislead into believing that the restated amount reflects a current value. There may be

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[13]Heath, p. 462-463.

[14]AICPA Accounting Current Text, § 1071.41.

[15]William D. Bradford, "Price-Level Restated Accounting and the Measurement of Inflation Gains and Losses," The Accounting Review 49 (April 1974): 304.

[16]Robert S. Kaplan, "Purchasing Power Gains on Debt: The Effect of Expected and Unexpected Inflation," The Accounting Review 52 (April 1977): 369-78.

some confusion between general price-level accounting and a form of current value accounting. The adjustments made to the financial statements reflect changes in the general price level, rather than changes in the price level of a specific commodity or asset. An item on a general price-level financial statement which has been adjusted from its acquisition cost will not reflect a current value except by coincidence; in which case the price level for that particular item will have moved in the same direction and by the exact amount as have prices in general. Financial statements adjusted for inflation will not give either the current value or the replacement value of a particular item because specific prices may change at a different rate or even in a different direction than the general price level. The price of a specific commodity such as silver, for example, may decline over the same period that the general economy experiences inflation.

Note that some measure of a particular item's current value is affected both by the inflationary trend of the economy in general and by the particular item's value relative to other goods and services. General price-level accounting is not synonymous with current value accounting. These two concepts, general price-level accounting and current-value accounting, should not be construed to be incompatible nor mutually exclusive. Whereas general price-level accounting will not necessarily disclose the current value of a plant asset, neither will any type of current-value accounting specifically reveal the impact of inflation. The objection that price-level accounting will result in confusion for the reader may suggest the need for an educational effort on

the part of the accounting profession rather than suggesting that this information should not be presented.

A similar objection has been voiced concerning the presentation of price-level adjusted statements as supplementary information. This criticism of inflation accounting suggests that showing two separate sets of financial statements may cause statement readers to question the validity of both presentations.[17]

Usefulness Lacking

A more fundamental objection to general price-level accounting than that the stated amounts may be confused with current value is the objection that price-level accounting lacks usefulness because what is needed is current values.[18] A more thorough discussion of current value concepts is presented in chapter five. The remainder of this section will consider only the more general objection that the data elicited from price-level adjusted financial statements lacks usefulness to statement readers.[19] The contention is that the data manipulations required by inflation accounting do not yield information relevant to the decisions made by statement users. In commenting on the public's need for general price-level information, Walter Wriston stated:[20]

> The intellectual accounting exercises which are now starting to move from drawing room dialogues

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[17]Walter T. Marek, "Reflections on Price-Level Accounting," Financial Executive 42 (October 1974): 26-8.

[18]Backer, pp. 143-154.

[19]Stickney and Green, pp. 25-30.

[20]Walter B. Wriston, "Accounting to Whom For What?" Financial Executive 44 (September 1976): 13.

> to the marketplace appear to be entirely self-propelled in the sense that virtually no one outside a relatively small group of accounting theorists is demanding such sweeping changes.

Stickney and Green have also questioned whether there is any improvement in the statement user's ability to evaluate management's effectiveness, or the maintenance of capital, that is provided by price-level adjusted information. Like many other writers in this area, they suggest that current values may enhance financial statement interpretability.[21] The next chapter expands on this concept.

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[21]Stickney and Green, pp. 25-30.

CHAPTER V

CURRENT VALUE

As noted in previous chapters, a number of accountants have called for the implementation of current value accounting. The practice of historical cost accounting is, to a large extent, regulated by the opinions issued by the Accounting Principles Board, statements advanced by the Financial Accounting Standards Board, and other entities which influence generally accepted accounting principles. The practice of general price-level accounting is strongly influenced by the codification of procedures in APB Statement No. 3 and the theoretical investigation of Accounting Research Study No. 6. Unlike these two methods of financial statement presentation, there is no authoritative pronouncement governing current value accounting. Since there is no formalized statement on the topic, a number of variations in approach have been suggested which have become subsumed under the heading current value accounting.

This chapter is intended to contrast and compare general price-level accounting with the proposals for current value accounting. To that end the chapter will first define the subject matter and then proceed to contrast these two concepts; current value and general price-level accounting. In the final section of this chapter, a proposal for the integration of these procedures will be described.

Terminology

The phrase "current value" has been used as a general term to refer to any valuation method other than historical cost and general price level.[1] One type of current valuation proposed is "replacement cost." The replacement cost of an asset is the amount that would have to be spent to acquire the same asset today; that is, to acquire an asset with the same productive capabilities. Actually a further distinction can be drawn between "replacement cost" and "reproductive cost" where replacement cost is oriented toward obtaining the best available facilities that will continue to produce the same output, whereas the reproductive cost is directed toward the replication of the same asset but at current prices. These two valuation methods should produce the same results except when there have been significant technological changes to render the identical asset obsolete.[2]

The replacement cost of a facility could be approximated by the development of specific price indexes. Unlike the comprehensive price index such as the GNP deflator which attempts to measure price-level changes pervading the entire economy, a specific price index is directed toward the measurement of price change for a given commodity or a specific industry. The use of specific price indexes provides a more objective means of approximating the replacement cost of a firm's productive capacity than

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[1]Robert T. Sprouse, "Understanding Inflation Accounting," The CPA Journal 47 (January 1977): 23-26.

[2]Morton Backer, Current Value Accounting. (New York: Financial Executives Research Foundation, 1973), pp. 189-209.

appraisals or engineering estimates.[3]

One of the central attractions to replacement values is the presentation of updated asset values. An historical cost accounting statement of earnings presents the income accruing to the firm from the productive use of its assets. But the statement reader is generally interested in the enterprise's ability to continue to generate earnings. It is assumed that the firm is a going concern, but the cost of replacing its assets and thus maintaining its capacity is not disclosed in the traditional income statement.[4]

Another type of current valuation proposal is "current exit value." Current exit value refers to the net amount of cash that would be received in an orderly liquidation of the firm's assets and liabilities.[5] Current exit value is the amount that could be obtained by the sale of a given asset or the systematic disposition of the plant. The concept of current exit valuation is also referred to as "net realizable value" and "current market value." This valuation sets a minimum valuation at current prices and is particularly relevant where a liquidation is contemplated. The current exit value is not necessarily different from replacement cost and the two values may often be expected to coincide. If there is a currently existing market, especially with quoted market prices, the two methods would likely yield the same results.

A third type of current valuation is "net present value"

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[3] Ibid.

[4] Ibid., pp. 206-207.

[5] Sprouse, p. 25.

(or "discounted value of future cash flows"). Net present value is determined by discounting the expected future cash flows that relate to the asset or liability by an appropriate interest rate. This concept has considerable theoretical appeal and has been applicable to some decision-making processes. Unfortunately, the approach requires management to make some very specific estimates which for some assets may be difficult to determine and to verify. Consequently, the net present value approach may not be practical for external reporting.[6]

All three of the methods briefly described in the preceding paragraphs would revalue the outdated asset values presented on traditional financial statements prepared according to generally accepted accounting principles. This revaluation is expected to benefit the statement reader by informing him of a "current value." In addition, holding gains or losses would be disclosed. Holding gains represents the difference between the assets' acquisition cost and the restated current value. Note that as stated in this manner, the specific effect of a general price-level change is not disclosed.

Conceptual Contrast

General price-level accounting is a restatement procedure by which conventional dollar amounts expended at different dates are expressed in terms of the same unit of current purchasing power. General price-level accounting does not represent a departure from the cost principle. The application of the conversion process is

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[6]John A. Bullard, "Price-Level Restatement and Valuation Reporting," Management Accounting 57 (February 1976): 18.

not a different accounting system. The historical cost concept is not violated. General price-level accounting changes historical costs measured in terms of monetary units in different periods to historical costs measured in terms of general purchasing power units. Both the traditional statements and the price-level adjusted statements are based on the cost principle. The restated amount still represents cost rather than a current value.[7]

On the other hand, current value accounting would be a departure from the present accounting model based on the historical cost principle. When adopting general price-level accounting, one merely changes the unit of measurement. But when adopting a form of current value accounting, one changes the attribute being measured. The attribute changes from an historical or acquisition cost to a current value. As previously discussed, the term current value includes a variety of proposals suggesting different bases for making this valuation.[8]

One of the more objective ways to determine a current value is by the application of specific price indexes. Specific price indexes are published for several different types of commodities and industrial groups; including various machinery and construction equipment. Because of supply and demand shifts and technological innovations, the specific price index may measure the price-level changes that a particular company will experience more accurately than a general price index. Assuming that the

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[7]American Institute of Certified Public Accountants, Accounting Current Text. Professional Standards volume 3, (Chicago: Commerce Clearing House, Inc., 1977), § 1071.05.

[8]Sprouse, p. 25.

entity is a going concern and perhaps locked in to a rather narrow pattern of operation within the economy, these specific price index-adjusted values may provide more relevant information to the financial statement reader. For a particular industry the specific price index would be more useful if the costs of its operations are increasing at a rate faster than the general level of prices, or perhaps even moving in a direction opposite to that of the general price level.[9]

A major difference between general price-level accounting and current value methods is the approach to presenting gains or losses from price changes. General price-level statements report purchasing power gains or losses; gains or losses that accrue to the enterprise from holding net monetary assets and liabilities. The general price-level approach essentially ignores any holding gains existing at the time of the adjustment process. Consequently, the general price-level adjustments will not disclose the current value of an asset except by coincidence. On the other hand, current value accounting will not directly reveal the impact of inflation. These inflationary effects are disguised in the reported holding gains. Both of these innovations in financial reporting, general price-level and current value, have been designed to adjust for certain effects of changes which a company might experience. Both are intended to provide the financial statement reader with more useful information but their orientation and results differ. However, these two concepts, general price-level accounting and current value accounting, should not be construed to be incompatible nor to be mutually exclusive.

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[9]Bullard, p. 17.

Integration

Methods of integrating these two methods have been proposed. For example, Largay and Livingstone have suggested a procedure for incorporating a form of current value accounting into the price-level adjustments. These accountants have termed the resulting product "price level adjusted replacement cost financial statements."[10] The authors view this technique as a solution to two distinct problems. The first is a measurement problem. General price-level adjustments restate all values into units of the same purchasing power. The standardized measuring unit helps to alleviate the difficulty caused by the elasticity of the dollar. The second problem is a valuation problem. Replacing historical valuations with current values provides information which reflects the current conditions in the goods and capital markets.[11] This reevaluation allows holding gains to be recognized in the period in which they occur.

The purpose of this chapter has been to distinguish between general price-level and current value accounting. Each approach offers unique features which may be effectively combined for a more informative presentation.

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[10] James A. Largay, III and John Leslie Livingstone, Accounting for Changing Prices. (New York: John Wiley and Sons, Inc., 1976), pp. 259-282.

[11] Ibid., pp. 259-260.

CHAPTER VI

SUMMARY AND CONCLUSION

This paper is intended to provide an analysis of general price-level accounting. At this time no authoritative body in the United States requires price-level adjusted information as an integral part of the financial statement presentation. Although not required for the fair presentation of accounting data according to generally accepted accounting principles, the APB has sanctioned the use of general price-level accounting in providing supplemental information. Nevertheless, few companies provide such information.

The purpose of general price-level accounting is to adjust historical-dollar financial statements for changes in the general purchasing power of the dollar. The item amounts are restated, but the adjustment still represents cost and not a current value. The basic difference between the traditional financial reports and general price-level financial statements is the unit of measure. Amounts are reported on price-level statements in general purchasing power units rather than monetary units. Advocates of this procedure claim that price-level restatements will improve the meaning and interpretability of profitability and provide the statement reader with useful economic information.

The conversion from monetary units to purchasing power units is basically a mechanical procedure. Holders of monetary assets

during periods of inflation incur a loss in purchasing power. Holders of monetary liabilities during the same period experience purchasing power gains. A unique feature of price-level accounting is the inclusion of purchasing power gains or losses on the price-level adjusted income statements.

General price-level accounting is not without deficiencies, and various criticisms have been levied against its implementation. A major source of concern for the critics is the general reliability of the price indexes employed. Some accountants have objected that general price-level accounting yields results that lack usefulness. Many of these critics contend that what is really needed is current values. A further criticism suggests that the general price-level data will be confusing to non-accountant statement readers. The monetary-nonmonetary distinctions required for the application of price-level techniques have been questioned as arbitrary.

Current value accounting, which is another innovative concept and controversial accounting topic at present, is occasionally confused with general price-level accounting. Current value accounting may be distinguished from general price-level accounting by the former's emphasis on a revaluation of the firm's assets and liabilities at current price and the concommitant holding gains which result. Current valuation is an attempt to solve a valuation problem and is a departure from the historical cost concept, but does not specifically reveal the impact of inflation. On the other hand, general price-level accounting is an attempt to solve a measurement problem; that of removing the elasticity from the measuring unit. This procedure discloses the effects of

changes in the general price level, but does not disclose the current value. However, these two concepts should not be viewed as alternative courses of action, and some writers have proposed procedures that would integrate general price-level adjustments with a form of current valuation.

In the opinion of this writer, there is ample evidence of the distorting effects of price-level changes on financial statements to support the implementation of general price-level adjustments for supplemental information. It appears that such a disclosure would indeed provide useful information to the reader. In particular the adjustments would remove the distorting effects of inflation by converting historical amounts to a single unit of general purchasing power.

This is not to say that the many serious objections to price-level accounting are without merit. Most accountants, for example, would recognize the imperfection inherent in the development of price indexes. Nevertheless, the question posed at the beginning of this paper asked whether financial reporting should be altered to reflect changes in price level consistent with the recognized principles of financial statement presentation. Some of these principles include comparability, completeness, and understandability as well as providing reliable information about economic resources and obligations and economic progress. In this writer's opinion the evidence presented in this paper supports an affirmative answer. General price-level accounting would be a useful tool to reflect the changes in price level.

The desirability of adopting a form of current value accounting is more difficult to evaluate in part due to the many variations

offered without any authoritative direction. From a theoretical point of view, accurate current values would appear useful. But from a more practical perspective the objectivity and auditability of the information yielded by the proposed methods is questionable.

In the investigation of this topic, it appeared to this writer that research was lacking on the behavioral impact of price-level or current value implementation. It might be informative, for example, to compare the decisions that would be made by sophisticated statement readers on the basis of information provided under historical cost, general price-level, and current value assumptions. It is not clear how much information currently presented is actually utilized externally to make decisions.

Whatever direction the accounting profession takes in the future in this area, it would seem that a major educational effort is advisable to gain the acceptance and support of nonaccountants who utilize accounting information.

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