Price Level Changes And Financial Statements

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PRICE LEVEL CHANGES
AND
FINANCIAL STATEMENTS

by

JAMES W. WHITE

A Thesis
Submitted to the Department of
Business Administration of Carroll College
In Partial Fulfillment of the Requirements
For Graduation with Honors

Helena, Montana
April 1, 1964

Approved

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CARROLL COLLEGE
To Mom and Dad

for making my
education possible
ACKNOWLEDGEMENTS

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J. W. W.
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   --conventions
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B. A case for conventional accounting

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A period in which prices in general are rising is spoken of as a period of inflation. Conversely, the term deflation applies to a period in which the prices in general are falling. A key to an understanding of the effects of inflation and deflation is in terms of the purchasing power of the dollar. In other words, one must realize that a dollar is only worth what it will buy. It follows from this that a dollar in one period can be compared with a dollar in a different period only if there has been no significant change in the general level of prices (for a change in the general price level necessitates a change in the purchasing power of the dollar). If such a change has occurred, a comparison of the two periods can be made on equal basis only if the change is somehow taken into account.  

We are in the habit of thinking of a dollar as a dollar regardless of when it was received or spent, although available facts show that there are weaknesses in this assumption.

Although inflation in the United States may be said to have begun in earnest about 1915 during the First World War, we have had five periods of important price fluctuations since 1775. Each of these periods had occurred during or following a major war. Between 1774 and 1779 (Revolutionary

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War), wholesale prices rose almost threefold. Between 1811 and 1814 (War of 1812), wholesale prices rose about 50%.
The Civil War (1861-65) saw wholesale prices slightly doubled. The wholesale price index more than doubled in the periods 1915-20 (World War I) and again in 1940-51 (World War II).

In other words, a 1926 dollar was:

- worth $0.52 in 1774 and $1.55 in 1779,
- worth $1.04 in 1811 and $1.54 in 1814,
- worth $0.61 in 1861 and $1.32 in 1865,
- worth $0.69 in 1915 and $1.54 in 1920, and
- worth $0.78 in 1940 and $1.80 in 1951.

As we saw, each of the major increases in prices since 1775 has been associated with a war. Although the forecasting of future wars is a matter of conjecture, there are some reasons for believing that the trend in prices for the near future will be upward. Aside from any effects a future war may bring, the principle cause of inflation today is the magnitude of money income generated in the economy and available for expenditures by the people. Wage increases in excess of labor's share of the increased productivity arising from technological improvements necessarily result in further spirals of the price level. It has been estimated that because depreciation is based only on historical costs, a corporation must charge its customers $2.08 for each $1.00 excess of current cost over original cost. Because of Federal income taxes, a corporation would not be able to maintain its productive capacity without
We are now living in a time threatened with war, and are in at least a quasi-war-economy. The present outlook seems to indicate deficit spending for war preparation; the threat of depression has, for the most part, disappeared and with it has gone the disposition to save, either for security or in response to patriotic appeals. These conditions are tantamount to an inflationary spiral. As prices rise, buying, credit, and production increase, plants expand, and demand runs high.

In addition to the indications towards higher prices, there are at least two forces which tend to prevent any great price decline. First, the power of labor unions seem to insure that our wage structure will not yield to much reduction. Second, the government can be expected to try to prevent any recession of price levels in an effort to keep the Federal debt from rising. Although the forces of labor and the government are not likely to outweigh the controlling effects of war and peace, the likelihood of any deflationary trends are small.


3. EFFECTS OF INFLATION

The most important accounting and financial problems caused by inflation relate to non-monetary accounts, such as inventories, fixed assets, and depreciation. The monetary accounts do have their own particular problems, but they are largely minimized in relation to the nonmonetary accounts.

A balance sheet account is monetary if it consists of cash or if it represents a claim to, or obligation to pay, a fixed sum of money. All other balance sheet accounts are nonmonetary. For all practical purposes, monetary revenues and expenses are directly comparable at any one time, or for a short period, without any conversion or adjustment. This is due to the nature of the accounts in that they are necessarily expressed in current dollars.\(^5\)

The distinction between monetary and nonmonetary accounts is generally clear, although there are a few borderline cases. In general, the principle balance sheet accounts can be classified as follows:\(^6\)

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\(^6\) Jones, *Effects of Price-Level Changes.....*, p. 9.
What is the effect of inflation on accounting? A financial record will be consistent as long as the purchasing power of the dollar is reasonably stable. However, in times of inflation, the account figures become distorted by the shifting value of the dollar. The principal point is this: the dollar is not a constant or consistent measuring unit. Consequently, the dollars of different years represent different amounts of commodities and services as expressed in the general price level and/or the purchasing power of the dollar. The accounts of most businesses contain dollars reflecting transactions in both the current period and in past periods.  

For example, the charges for the depreciation, depletion, and amortization of fixed assets, as well as the valuation of investments, are calculated on the basis of original (historical) costs and are therefore expressed in past dollars. On the other hand, gross and net income, dividends, and most other financial items are measures in the current dollars of the day.

The income statement figures lack comparability because of the failure of depreciation and other similar costs to reflect the current price level. As a result, the reported net income figure loses some of its significance because costs of the nature of those mentioned above are not comparable. Similarly, the balance sheet suffers from a lack of comparability of various items. Cash, receivables, and unpaid liabilities are expressed in current dollars, but inventories and fixed assets, especially plant and equipment, are collections of non-comparable items for they most always consist of various past-period dollars. As a result, the purchasing-power gains and losses are undisclosed.

Generally speaking, inflation results in losses that may be characterized as either recoverable or unrecoverable. Un-recoverable losses are those produced by the decline in the purchasing power of the dollar. In a business enterprise, this applies to the working capital, or excess of current

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Mason, p. 11.
assets over current liabilities. An example of this exists when it takes $105 to purchase at year’s end what $100 would have purchased at the beginning of the period. It is obvious, therefore, that an unrecoverable loss of a part of the working capital exists at the close of the period.  

Similarly, there are losses which take place in assets that are used during a long period of time. The losses are, in a sense, recoverable in that the value of the property in terms of current dollars increases. For example, property costing $100 at the beginning of the period could have a value of $105 at year’s end (assuming a 5% inflationary increase during the period).

To pursue this further, the general nature of the difficulty can be seen in the accounting for assets. When assets are purchased, they are normally recorded on the basis of the actual money cost on that particular date. If an inflationary rise in the price level occurs, subsequent transactions relating to these assets will be recorded in terms of the depreciated dollar.

This problem has many facets. One facet concerns the depreciation of fixed assets. In times of high prices fixed assets must be replaced at costs considerably higher than the

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10 Ibid, p. 53.
book amount of the assets. A second aspect concerns the basis of inventory valuation. Just as fixed assets have to be replaced when they are used up, so do inventories of goods have to be replaced when they are sold. In periods of rising prices, the cost of replacing stocks will be greater than the cost of the stock replaced.

Because our discussion will be centered around price levels and price-level indexes, it is best that we now determine exactly what a price level is. This is best explained in terms of a chart. If the prices of all commodities and services for a period of time were charted, it would be possible to observe a general trend even though some prices rose and some fell more than others. It is this general trend and the resulting average situation at any one point of time that is called a price level.

In most cases, a general price level is constructed as follows:11

1. Select certain commodities and services to be used in the calculation. Obviously, not all commodities and services can be used and a representative group must be selected.

2. Assign appropriate weights to each commodity and service used in the calculation.

3. Select a base period or date.

4. Calculate the price of each commodity and service as a percentage of the price at the base period or date. For

11 Mason, pp. 1, 2 and 4.
example, if the price of an item is $10 at the base date and $15 on the date under consideration, the percentage is 50%. We could then say that the cost of this item is 150% of its cost at the base date, or that the purchasing power of the dollar has dropped 33 1/3 % (and $1.00 now would be equal to only $0.66 2/3 in the base period).

To show how changes in the price level affect the earnings of a company the results of a study that appeared in the June 1960 issue of *Journal of Accountancy* are presented below. This study showed the results of the Reece Corporation over a ten-year period (1949-59) in which the purchasing power of the dollar decreased 17%. (It had decreased 52% since 1939).

The information for this study was compiled and prepared by the Reece Corporation. For seven years, up to 1959, this company prepared supplementary statements to accompany their regularly audited statements, although the supplementary statements were not themselves audited. "As in past years, we have converted the Company's financial statements from Historical Dollars (those used in conventional accounting and in our reported figures) to Uniform Dollars (defined as uniform measuring units when the purchasing power is equal to 1959 dollars)."

The following information was found to represent in-
creases in certain areas from the 1949 level.\textsuperscript{13}

<table>
<thead>
<tr>
<th>Year</th>
<th>Historical</th>
<th>Uniform</th>
</tr>
</thead>
<tbody>
<tr>
<td>86</td>
<td>52.5</td>
<td></td>
</tr>
<tr>
<td>50</td>
<td>42</td>
<td>19</td>
</tr>
<tr>
<td>19</td>
<td>43</td>
<td>17</td>
</tr>
</tbody>
</table>

To understand the significance of the data, further information concerning the results may be helpful. In regard to the inventories, the increase was required to handle an increase in the volume on business and a greater diversity of product. Although there was a 19\% increase in fixed assets after depreciation in Historical Dollars, this amounted to 5 of 1\% decrease when expressed in Uniform Dollars. This is particularly important because it shows that no real growth in fixed assets occurred although investment in fixed assets was substantially more than the related depreciation allowances. Finally, net worth increased \$13.16 per share in Historical Dollars. In Uniform Dollars, the increase was \$8.55 per share. The \$4.61 difference "represents the erosion of capital caused by a 17\% loss of purchasing power of the dollar and the necessity to provide reserves in excess of normal depreciation allowances in order to replace plant assets."
and equipment. n14

This additional information is offered for your consideration:

<table>
<thead>
<tr>
<th>1959 Income Data</th>
<th>Historical</th>
<th>Uniform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>6,282,000</td>
<td>6,282,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>662,000</td>
<td>731,000</td>
</tr>
<tr>
<td>Federal and Foreign taxes (as a percentage of net income before taxes)</td>
<td>51.8%</td>
<td>55.0%</td>
</tr>
<tr>
<td>Net income</td>
<td>767,000</td>
<td>675,000</td>
</tr>
<tr>
<td>Earnings per share (common) after preferred dividends</td>
<td>3.93</td>
<td>3.44</td>
</tr>
<tr>
<td>Earnings retained after dividends</td>
<td>503,000</td>
<td>411,000</td>
</tr>
</tbody>
</table>

C. A CASE FOR CORRECTION

Because the purchasing power of the dollar does vary from period to period, many contend that the existing stable dollar assumption is false. Because dollars of different worth are added and subtracted in the accounts, many feel the resulting net income figure and the account balances are subject to misunderstanding. The real harm here is that statement readers, although usually aware that such practices exist, have a tendency to regard the resulting balances

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14 Ibid.
15 Ibid.
as being of current worth. Most accountants also feel that difficulty lies in the belief that no major consequences will result from ignoring these fluctuations.

Among those items carried in financial statements largely on the basis of recorded facts are cash accounts receivable, inventory, accounts payable, net sales, the cost of fixed assets, and the like. The amounts these items are carried at are based upon recorded historical transactions. They have been recorded in the books of account in exact dollar-and-cent values of a certain time, or over a certain period of time. Of the items listed, fixed assets are of importance because the components of it are carried at dollars of different value. All other items, excepting inventories, are carried at approximately current values.

During periods of fluctuating price levels, the value of the dollar varies considerably. As a result the depreciated economic (current) values of the various components of fixed assets often vary materially from the respective depreciated accounting values on the statement date, and the depreciation charged to the income statement will consist of dollars of different values. Consequently, accounting science may be inaccurate even though the records have been kept with exacting care.16

The discussion now centers around those who would gain from changes in accepted accounting procedures. Broadly speaking, management, investors, and the government, among

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16 Foulke, pp. 597-8.
others, stand to gain by the use of financial data that has been adjusted for changes in the value of the dollar. Because the area covered in the above statement is vast and beyond the scope of this paper, the author will merely indicate a few of the general ways in which the indicated parties could benefit from price-level adjustments.

The providing of better information for management is an obvious use of figures adjusted for price-level changes. Management needs to know how their companies have been affected by changing prices, and they cannot obtain this information merely by knowing how inflation has affected business in general. Management must be aware if amounts representing capital recoveries are going to the government through taxes or to stockholders by means of dividends. Information of this nature is important in maintaining real capital in the short run. More important, it is essential that such information be available in making long-range plans for development and expansion.  

For informal reporting, the use of uniform dollars would eliminate the misleading nature inherent in reports based on historical costs. Although such a procedure may prove confusing, it would be considered better than misleading those who read the reports. Because of the inflationary trend today, many companies can present factual

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data showing rapid progress and expansion. The effects of inflation can reduce these reports to mere illusions of growth or expansion at rates which are unrealistic. Reports based on current dollars can reveal the real trends measured in units of uniform values.

Although it is generally agreed that the most important single influence of financial statements in recent years has been the decline in the value of the dollar, little has been done to reflect this in financial reporting. It is true that any change in the official certified statements is an unlikely occurrence. However, it is equally true that such statements cannot be correctly interpreted without taking into account significant changes in the value of the dollar. Many feel that it is time for a general agreement on basic methods for making those adjustments. 18

The fourth consideration, regulation, is concerned mainly with public utilities. Utilities, because of the nature of their services, are free from direct local competition. It is, therefore, the purpose of regulatory agencies to protect the consumers from excessive charges. The rates charged must be high enough to attract the necessary capital, but not so high as to produce monopoly profits. If changes in the price level are taken into account when the rates are set, it is believed that the rates and the resultant earnings

18 Ibid., pp. 145, 8, and 8.
can be stabilized to provide for adequate returns in inflationary or deflationary periods.\(^{19}\)

Finally, we come to the matter of taxation. By not going into this matter extensively, the author realizes that he is excluding an area very vital to the problem of price-level changes. I do not, however, feel that this subject fits precisely into the scope that I will outline presently. In regard to the taxation problem, the following statement applies: Recently, there have been many suggestions in the area of "revising the income tax law for the purpose of eliminating the tax on real capital recoveries which now applies whenever original costs in historical dollars are below original costs measured in present-day dollars."\(^ {20}\)

Although the deficiencies mentioned previously are generally recognized today, there are many who recommend that no changes be made. The arguments favoring the retention of historical costs run as heavy as those favoring the recognition of price level changes in the accounts. My purpose here is to present the problem as it exists today (which I have done), show what has been tried in the past to

\(^{19}\) Ibid., pp. 155-6.

\(^{20}\) Ibid., p. 158
correct it and what remedies are proposed for the future. Finally, I will indicate the position held by the American Institute of Certified Public Accounts (AICPA), the American Accounting Association (AAA), and members of the accounting profession in general.
CHAPTER II

REMEDIES THAT HAVE BEEN TRIED
In a study by the Committee on Concepts and Standards Underlying Corporate Financial Statements of the American Accounting Association in 1953, the Committee reached some general conclusions regarding inventory pricing and price changes. In their opinion the principal defect of the realistic flow assumptions of inventory pricing (the realistic flow assumptions—fifo, identified cost, etc.—approximate the actual physical movement) does not lie in the matching process as some believe. Rather, it lies in the commingling of dollar data of various purchasing power capacities. The result is one of erratically fluctuating profits during periods of sharp price movements. This would tend toward overstatement of real profits during periods of general price increases, and understatement during periods of general price declines. 21

To soften the impact of taxes, and to improve the distortion of reported profit figures, there has arisen in recent years a movement toward artificial flow assumptions. Chief among these is the lifo method of inventory valuation.

Lifo, in essence, consists of “assigning to the balance

of goods on hand at the end of the year a valuation which represents the oldest recorded historical costs at which the existing goods could have been purchased.\textsuperscript{22} The effect of this is to charge against the revenue of a period the historical cost of the goods equal to the quantity purchased and the quantity sold during that period. Artificial lifo has appealed to some in that it matches current costs with current revenues. This is particularly significant in times of changing price levels.

The important thing to remember about lifo is that it is not a method of inventory valuation, as in fifo and average cost. Very rarely does it describe the actual flow of goods or show the cost of goods actually in the inventory. It is rather a device for charging the replacement costs of goods sold against the revenues from sales. Lifo is equally effective in times of stable or unstable prices.

The widespread adoption of lifo in recent years is due primarily to inflation and high income taxes. As one author stated: "Lifo may, therefore, be regarded as the businessman's answer to the problem of price level changes insofar as it affects inventories."\textsuperscript{23} In his opinion, companies who adapted lifo early and used it consistently found that their cost of goods sold, gross profit, and net income figures were

\textsuperscript{22} Ibid., pp. 37 and 39.

\textsuperscript{23} Jones, \textit{Effects of Price-Level Changes}..., p. 128.
more realistic than they would have been had they continued to use fifo or average cost methods.

Lifo, however, does have its limitations. Of the two principal objections, the first is that lifo adjusts the wrong inventory in the wrong direction. The basic purpose of lifo is to eliminate inventory profits by using identical prices for all, or most all, of the opening and closing inventories. To do this, segments of the closing inventory are priced at opening inventory prices. The argument, as presented, states that since current statements are presumably expressed in current dollars, would it not be better to do just the reverse of the above? That is, to apply today's prices to the opening inventory rather than yesterday's prices to the closing inventory. It is said that such a procedure would eliminate the discrepancies between lifo and fifo without impairing the lifo effect on income. At the same time, lifo inventories would be stated in current costs.

A second objection to lifo concerns the erratic effects sometimes produced by using this method. If, for example, something were to arise that would necessitate the depletion of available stocks of goods, inventories once carried at historical costs would now have to be carried at current costs. This would distort the book incomes of the current and preceding periods as well as the trends of inventory pricing. 24

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Ibid., p. 129
To appraise the lifo method, the following point must be considered:

1. To the extent that the general price changes match the price changes of goods in the inventory, the resulting profit figures would be superior to those attained under the realistic flow assumptions of inventory pricing. To the extent that they do not, lifo would distort any real gains or losses.

2. The inventory valuations resulting from lifo may become so far out of date that it would be misleading. For this reason, the Committee advocates disclosure of the current value of the inventory.

3. By using lifo, management could influence profits by expanding or contracting inventory quantities. In extreme cases, last minute purchases could be treated as the goods sold over the entire period. Intentional depletion for the purpose of influencing the profit figure would be possible. The Committee, however, doubts that such abuses would actually happen although they are possible.

4. In the event of a temporary depletion of lifo inventories, net income for the period would receive the full impact of all previously unrecognized gains or losses. Such action would be misleading of the current periods performance.

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American Accounting Association, Accounting and Reporting Standards..., p. 129.
To conclude, The Committee on Concepts and Standards Underlying Financial Statements recommends that figures as to inventory valuation and related operating costs under realistic flow assumptions be included whenever lifo inventory methods are used. Under these conditions, says the Committee, lifo has some usefulness at the present time. They do recommend that, if and when techniques for reflecting in accounting reports the impact of price-level changes are accepted, lifo should be abandoned. In its place would be a method advocating the realistic flow assumptions.

B. ACCELERATED DEPRECIATION

The Revenue Act of 1954 provided for several liberalized methods of depreciation. Among them were two methods of accelerated depreciation—the declining-balance method and the sum-of-the-years-digits method. Although it is difficult to say why these methods were adopted, two reasons stand out. The first was the desire to stimulate and facilitate the investment of funds in plant and equipment. This would establish conditions favorable for the continuance of the rapid rate of growth in the economy which characterized

Ibid., p. 37
the postwar years. The second reason gave recognition to the effects of inflation on the fairness of depreciation charges.27

Depreciation, to accountants, deals with the cost of an asset and not its value. The objective of depreciation accounting is to allocate original asset cost to the accounting periods which will benefit from the use of said asset. Because we lack fore-knowledge of future costs and benefits, this objective, in its pure form, can never be attained. Instead, various formalized methods have been developed, each one suitable to a different situation.

In general, methods of depreciation are based on three major patterns of service value. They are: (1) the level series—characterized by compound-interest methods of depreciation, (2) the gradually declining series, as evidenced by straight line depreciation, and (3) the rapidly declining series—characterized by reducing-charge (accelerated) methods.28

Because of the growing recognition of the serious effects of inflation on depreciation deductions, the presumption in favor of the reducing-charge methods is strong. Under stable conditions, the straight line method can be strongly justified on theoretical as well as practical methods. The long-term

27 Jones, Effects of Price-Level Changes...., p. 128.

28 Ibid, p. 113.
trend of prices, however, is still upward as it generally has been, and the accelerated methods seem to be more justifiable.

It must be pointed out, though, that the reducing-charge methods do not compensate for the effects of price level changes except to a limited degree. While the prospective tax savings are not large when viewed over the whole service life of the asset, the immediate tax savings may be fairly substantial. This can be especially advantageous to corporations undertaking major expansion programs. While such methods do produce more realistic figures for net income, they create at the same time an understatement of new capital employed.29

The major depreciation problem today is not the spreading of historical dollar costs over succeeding periods, but rather the measuring of capital exhaustion costs over those periods in real terms. Reducing-charge methods, or accelerated depreciation, offer some advantages, but they do not correct the wide discrepancy between real and nominal capital exhaustion costs.30

C. RESERVES

29 Ibid.

30 Ibid., p. 158
The use of contingency reserves established by charges against income would accomplish the purpose of reducing the reported profits. In the past, such charges have actually been made. This procedure, however, lacks the orderliness, objectivity, and consistency which may be found in the methods that were just covered—lifo inventory costing and the methods of accelerated depreciation. For these very reasons, the Committee on Accounting Procedure of the American Institute of Accountants disapproved of this procedure in Accounting Research Bulletin 43 (1947). In practice, this method has virtually disappeared.\textsuperscript{31}

D. CONSERVATISM

Conservatism, as such, is a philosophy or attitude rather than an accounting principle. Conservatism results in favoring the understatement of assets and current income and the overstatement of liabilities and current expenses. Inherent in conservatism are such practices as valuing inventories at the lower of cost or market, providing for losses and not anticipating gains, and carrying property at original cost minus depreciation.

\textsuperscript{31} Wilcox, p. 259.
Accounting many years ago was naturally conservative since it was essentially on a cash basis. Many companies today (especially family-owned ones) keep net assets and profits as low as possible for various reason, including income tax purposes. Creditors, among others, have generally preferred conservative statements. Lately there has been a trend away from conservative statements. This is mainly because of constantly changing stock ownership and the shift in interest of creditors to earning power and away from liquidation values.32

Conservatism has led to a variety of accounting practices that are considered to be "generally accepted". Among these are the life method of inventory costing and the recording of accelerated depreciation for income tax purposes as compared to the straight line method. Also to be included are the practices of writing off doubtful accounts and establishing provisions for them. Conservatism may be seen in the inventory valuations of damaged or obsolete merchandise and in estimating the useful lives of temporary assets. Similarly, there may be a preference for taking extraordinary charges against income and charging extraordinary credits to surplus.33


33 Wilcox, p. 259.
One principal argument used against the recognizing of changes in the purchasing power of the dollar is that this would result in an upward restatement of assets. This is discouraged because of the difficulties encountered in the 1920's involving appraisal write-ups. Conservative policies regarding the recording of assets will aid in preventing another trend of that nature.

One area attacking conservatism centers around the idea that the lack of recognition of increased costs due to price level changes has tended to overstate profits. It is remembered that the overstatement of profits is in direct conflict with the basic idea of conservatism. It is obvious therefore, that conservative practices in some instances may misrepresent the facts as much as non-conservative ones.

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Catlett, p. 384.
CHAPTER III

PROPOSALS
In the period following World War I, accountants had to grapple with the problem of inflation, particularly in Germany, France, and Italy. Henry W. Sweeney made a study of the accounting methods used to maintain real values in those countries during that period of fluctuating price levels. To conclude his study, Sweeney wrote a book called *Stabilized Accounting.*

"Stabilized accounting is a method of converting values by means of an index number from cost or depreciated cost to current economic values." This would be done only when the general price level has varied at least 5 per cent within the period under consideration. In addition, this would apply only when most the asset, liability, and net worth items on the books at the close of the period first appeared on the books when the general price level was at least 5 per cent above or below its position at the end of the period.

To illustrate, assume a balance sheet with only two asset items—cash of $750 and fixed assets of $1,000. The cash of $750 is already stabilized in the current price level. The fixed asset cost $1,000 when the general index

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*Harper and Brothers, New York, 1936.*

35 *Foulke, p. 601.*
was 100. At the end of the current year, the index is 150. Consequently, $1,500 is needed to buy as many goods and services as the $1,000 could buy when the asset was acquired. Hence, at the end of the current year, the actual monetary outlay of $1,000 must be expressed as $1,500.

The depreciation of 50% on this asset must also be expressed in current dollars. This is accomplished by taking 50% of $1,500 (the adjusted cost). Thus, the charge for depreciation and the credit for the depreciation reserve both become $750. Similarly, the real value item, net worth, becomes stabilized in the price level of the current period.

The statements would look like this:

### Year of Purchase

<table>
<thead>
<tr>
<th>Cash</th>
<th>$ 750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Assets</td>
<td>$1,000</td>
</tr>
<tr>
<td>Net Worth</td>
<td>$1,750</td>
</tr>
</tbody>
</table>

### Current Period (without adjustment)

<table>
<thead>
<tr>
<th>Cash and Fixed Assets (as above)</th>
<th>$1,750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for Depreciation (50% x $1,000)</td>
<td>$500</td>
</tr>
<tr>
<td>Net Worth ($1,750 minus $500 depreciation)</td>
<td>$1,250</td>
</tr>
<tr>
<td>Net Worth (as above)</td>
<td>$1,750</td>
</tr>
</tbody>
</table>

### Current Period (adjusted)

<table>
<thead>
<tr>
<th>Cash</th>
<th>$ 750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Assets</td>
<td>$1,500</td>
</tr>
<tr>
<td></td>
<td>$2,250</td>
</tr>
</tbody>
</table>

36 Ibid.
Allowance for Depreciation (50% x $1,500)  
Net Worth*  

<table>
<thead>
<tr>
<th>Allowance for Depreciation</th>
<th>Net Worth*</th>
</tr>
</thead>
<tbody>
<tr>
<td>$750</td>
<td>$1,500</td>
</tr>
<tr>
<td>_________________________</td>
<td>________</td>
</tr>
<tr>
<td>$2,250</td>
<td></td>
</tr>
</tbody>
</table>

*Figure as follows:
Net Worth in year of purchase
Minus charge for depreciation
Balance in historical dollars

Balance adjusted for current dollars:
$1,000 x 150/100

In this method, the use of index numbers to stabilise values would be applied to assets, liabilities, and net worth, in that order. When completed, the residue of profit and loss remaining from the previous accounting periods to date would be available. To ascertain this residue, you would subtract the total stabilised liabilities from the total stabilised assets. This would result in two kinds of surpluses and deficits: realized and unrealized. The net amount may be zero, but there may be both a realized surplus and unrealized deficit, of the same amount, or vice versa.37

B. INDEX NUMBERS

Changes in the general price level demonstrate the instability of the monetary measure on which accounting balances

37 Ibid, P. 602.
are based. As a general rule, the revenues of a business are collectible in reasonably current dollars, and most expenses are payable in reasonably current dollars. The problem, therefore arises in the area of expenses that are based on historical costs. Under such circumstances, it is considered appropriate to substitute a "real" measure for the money measure used. The simplest way to convert a money measure into a real measure is through a general price-level index.

The defects in the medium of exchange as a standard of value has long been recognized. It is reported that the use of index numbers to adjust for the changing value of money was implemented in Italy as early as 1785. Similar practices were followed in England from about the beginning of the Nineteenth Century. In 1887, Alfred Marshall, famed British economist, claimed that there was no way to avoid speculation in the employment of capital. He suggested the adoption of a unit of value, as opposed to a unit of currency. This unit of value would be derived by the use of a price-level index.\(^{38}\)

No perfectly satisfactory index exists mainly because of poor price reporting and inadequate coverage. Since all prices do not move together, it is necessary to use an aver-\(^{38}\)

age of the different price movements. The average must be weighted, and an additional problem is encountered because the appropriate weights may change within a measuring period. But, for practical purposes, the theoretical imperfections of index numbers may be overlooked, and index numbers may be used until a more accurate way of measuring price level changes is found.

The purpose of restating conventional accounting figures by means of a general price-level index is to improve their usefulness. By this method, it is hoped that each dollar will represent the same amount of general purchasing power, and that the resulting financial statements will be stated in terms of a uniform or constant value unit of measurement.

The best, or certainly one of the best, of the available indexes to be used in converting historical dollars is the Consumer Price Index of the U.S. Bureau of Labor Statistics. It is possible, however, to construct an index of your own. The method for doing this was given in Chapter I.

By revising financial statements with the use of an index number, the effect of price level changes will be eliminated and each item will be stated in dollars of equal purchasing power. The results are still based on historical costs except that these costs have been converted into current dollars.

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There should be no need to change conventional accounting procedures, and such practices as inventory valuation, the calculation of depreciation, and the recognition of income will remain the same.

It is cautioned, however, that such procedures will not reflect the replacement costs of assets except by coincidence. It is because there is no change in the method to calculating depreciation that this is so. The only cost that will be recovered will be the original cost of the asset (as stated in terms of current dollars). In reality, the replacement cost of the asset in question may be more or less than the current-dollar amount of the old asset. This is possible because the index used to restate the historical dollars is, in most cases, a general index; individual indexes can be more or less than the general index. To reflect replacement costs would necessitate the using of a variety of special index numbers, one for each type of asset owned by the business.40

To convert historical costs into current costs, the dollar of a particular date or period must be selected as a base. It is then possible to restate all dollars into units of uniform purchasing power. One possibility is to take the year in which the company was organized and convert the current figures to equal the dollars of that year. An alternative is to use the base period of the index you are using. A commonly used base period is the period 1947-49. All amounts

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40Mason, p. 12.
would then be expressed in dollars of that period.  

To illustrate this procedure, I will use figures quoted in Ralph C. Jones' book, *Case Studies of Four Companies*. The base date for this study was December 1951, and the index on that date was 189.1. Mr. Jones used the Consumer Price Index in his study and the base period for this index at that time was 1935-39. In converting historical costs to current values, it is usually assumed that all monetary transactions of each year are expressed in average dollars of that year.

To find the purchasing power of the dollar for any period, the index for that period is divided into the index for the base period (189.1). For example, the purchasing power equivalent for a 1940 dollar is 188.2. This is determined by dividing 189.1 by 100.2—the index for 1940. Similarly, the value of a 1949 dollar expressed in December 1951 terms is 112.0 (189.1 divided by the index for 1949 which is 168.8). This method would be employed for all the historical costs to determine their December 1951 purchasing power equivalents.

An appropriate closing statement concerning the converting of historical dollars into current prices by use of a general price index is found in a pamphlet published by the Chase National Bank of New York City. This pamphlet shows the

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financial trend of operations of the American petroleum industry from 1934-47. The following excerpt concerns the results of such adjustments.43

The adjusted figures cannot have precise accuracy, but it is felt that they do reflect in a practical manner a close approach to the actual facts, and, therefore, will prove useful in indicating what has actually transpired—more so, at least, than the unadjusted figures.

C. VALUATION THEORY

In his book, *Truth in Accounting*, Kenneth MacNeal approached the problem of changing dollar values without the use of index numbers. He held that a vast majority of financial statements had to be misleading due to the unsound principles upon which modern accounting is based. His chief concern was that actual current values of many balance sheet items often differ greatly from their book, or accounting, values.44

43 Blough, p. 241.


44 Foulke, p. 602.
Because balance sheets do not generally reflect current economic values, MacNeal developed a new approach to be applied each period. Marketable assets should be valued at market price in the balance sheet, nonmarketable reproducible assets should be valued at replacement cost less depreciation, and occasional nonmarketable, nonreproducible assets at original cost. "This procedure would produce a balance sheet whose fluctuations of net worth (in any period) would describe accurately the net total of all profits and losses during that period from whatever source." Under such a procedure, depreciation would be the difference between the asset's valuation at the end of the present period and the asset's valuation at the end of the preceding period (the opening balance). Moreover, depreciation based on current economic values, in contrast to historical costs, would tend to recover from current operations sufficient funds to replace the physical capital consumed.

D. REPLACEMENT THEORY

During the 1940's when reported earnings contained inflationary elements, attention was given to the possibility of correcting that influence. Commonly suggested was the
elimination of inventory appreciation and of inadequate depreciation, the latter because it was based on original cost basis rather than the current replacement value. The amount determined for depreciation would then reflect the amount needed to recover the cost of the fixed assets used up in the current period at current dollar values. During a given year, the inventory inflation plus the inadequate depreciation allowances would be used to measure the amount by which reported earnings overstate real earnings.

To elaborate further on this, I would first like to discuss the adequacy of the depreciation charges. The proponents of conventional accounting hold that to depart from actual cost as the basis of matching expenses with income is to tamper with the factual data of accounting. The replacement cost supporters argue that the historical cost basis is not sound because actual costs are identified with past costs. Because it is obvious that the price level has risen, actual costs should reflect the present costs of producing revenue and not past costs.

What is needed is a method of accounting which will charge against income the real current cost of earning that income and avoid, as much as possible, changing the accepted basis of preparing the balance sheet. In a period of rising costs, profit and loss should be debited with the replacement cost of the asset used up, the asset should be credited with

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the historical portion of the expired cost, and a capital adjustment reserve account would be credited with the excess of replacement cost over historical cost. This method would be appropriate for either fixed or current assets.46

To illustrate, assume the following:

Machine purchased January 1 for £2,000

Replacement cost on December 31:

<table>
<thead>
<tr>
<th>Year</th>
<th>Replacement Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>£2,500</td>
</tr>
<tr>
<td>Year 2</td>
<td>£3,000</td>
</tr>
</tbody>
</table>

Estimated life: two years,
No scrap value,
Straight line depreciation.

At the end of Year 1, the entry for depreciation is:

- Depreciation Expense (1/2 replacement cost) £1,250
- Asset (1/2 historical cost) £1,000
- Capital Adjustment Reserve (difference) £250

For Year 2, depreciation is recorded thus:

- Depreciation Expense £1,500
- Asset £1,000
- Capital Adjustment Reserve £500

One objection to this method centers around the fact that assets may not be replaced when they wear out, and, if they are, they may not be replaced in kind. To a certain extent, this objection is defensible on the grounds that the capital represented by the existing assets must be recovered.

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from the business before a profit can be realized. Further, it is not enough that the original outlay be recovered if inflation has reduced the purchasing power of the asset's initial cost. It is the amount of purchasing power that was originally invested that must be recovered. Therefore, to charge depreciation on replacement cost is simply a rough method of maintaining real capital and not just money capital.47

As is evident, this method could be attacked on many fronts. The author feels, however, that the purpose of this paper does not warrant any further discussion of it. My purpose has been accomplished by its mere presentation.

To conclude my discussion of the replacement theory, I should briefly cover the second aspect of it. The statements to follow are those favoring the replacement cost theory with regard to inventory valuation. The valuing of an inventory at a realizable yield is merely an extension of reducing its value to the lower of cost or market. This is an established custom and the average accountant invariably accepts it. It follows from this, therefore, that an accountant should be equally as willing to mark up an inventory to its realizable value on the current market. To date, this practice has not been accepted.48

47 Ibid., p. 301.

E. ECONOMIC INCOME

Business today faces problems caused by high income taxes and inflation. Some businessmen would like to have accounting theories revised to recognize the increased cost of plant replacements in the determination of results from operations. Their argument charging that depreciation should provide for asset replacement is based on the economic concept of income, as opposed to the existing monetary concept. Also, it should be noted that the LIFO method of inventory valuation is not an entirely satisfactory approach. It is believed that the defects of LIFO would be lessened if the adjustments made were based on price level indexes.49

To emphasize their point, businessmen claim that although profits are high these profits might be called "accounting profits". In the first place, they include realized inventory profits. Secondly, the deductions for depreciation are estimated on the basis of cost as a recorded fact. The depreciated economic value of fixed assets is materially greater than the depreciated accounting values. Thus, accounting profits are higher than they would be if depreciation were calculated on current values.50

49 American Institute of Accountants, p. 83.
50 Foulke, p. 598-9.
They argue that the difference between real and nominal wages has long been recognized, and it is time that the same distinction be made between the economic income and the monetary income of a business enterprise. Before any economic income can be realized, the economic capital of a business must be maintained. Because the stable dollar assumption is obviously false, the need for a change is evident. They further state that unless the charges to operations for things used up are sufficient to replace those things, there can be no economic income. Consequently, the real capital is impaired regardless of what the books show as a monetary profit.51

There are many different ways of defining a real income concept. Attention here will be focused on two: real economic income and real variable income.

Real economic income of an enterprise is the real value (as opposed to the monetary value) of its ending equity minus the real value of its beginning equity plus the real value of any dividends. Under such conditions, it is possible for a firm to show a monetary profit, but have a loss in terms of the real value of the dollar. This would mean that although equity rose, it rose less than the general price level so

that its real value declined.52

Real variable income depends on net receipts and expectations thereof. An adjustment to the current year's net receipts can be computed and this adjustment would involve two components. The first part of the adjustment is expressed in money units of the beginning-of-year purchasing power. It is the difference between the value of net receipts expected at the beginning of the year and the value of these receipts at the end of the year. The second element, expressed in end-of-year purchasing power, involves the changes in the going value of an enterprise brought about by changes in expectations resulting from entrepreneurial activity. Either part of the adjustment, as well as the total adjustment, may be positive or negative. The real variable income then, is the sum of the real value of the net receipts for the period and the real value of the adjustment. This adjustment is based on the variation between actual net receipts, and any internally generated changes in the going value of the business.53

F. AMERICAN ACCOUNTING ASSOCIATION

52 Alexander, p. 189.

53 Ibid., p. 190.
In studying the problem of income fluctuations, the Committee on Concepts and Standards Underlying Corporate Financial Statements of the American Accounting Association in 1951 considered the following questions:

1. Is modification of the conventional accounting approach to net income determination to give effect to changing dollar values a desirable development?

2. If so, what methods are appropriate for measuring variations and disclosing them in financial reports?

3. If such modification is desirable, how is disclosure best accomplished?

The conclusions reached by the Committee, followed by a general discussion of them, were:

1. The periodic reports to stockholders prepared by management and verified by an independent accountant should, at present, continue to reflect historical dollar costs.

2. There is reason to believe that knowledge of the effects of price level changes upon the financial position and results of operations could be useful if a satisfactory method of measurement and disclosure can be developed.

3. The accounting effects of the changing value of the dollar should be made the subject of intensive research and

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55 Ibid., pp. 24-9.
experimentation. Study as to the problem itself and its solution should be made.

4. The adjustments upon financial statements for the effects of price fluctuations should be measured in terms of the over-all purchasing power of the dollar. Adjustments should not be based on either current value or replacement costs, but rather on changes in the general price level as measured by a general price index.

5. All statement items affected by price level changes should be adjusted in a consistent manner.

6. Management may properly include in periodic reports to stockholders supplementary statements which disclose the effects of price level fluctuations upon net income and financial position. Such statements should be reconciled in detail with the primary statements, and should be regarded as extensions to, or elaborations of, the primary statements rather than departures therefrom. Finally, these supplementary statements should contain comments and explanations concerning the implications and limitations of the adjusted data.

The Committee felt that financial statement data expressed in uniform "current" dollars would be useful for many purposes. Among these were the appraisal of managerial effectiveness in terms of the preservation of the current dollar equivalent of invested capital, analysis of earning
power, determination and justification of wage policies, and aiding the government in determining long-range policies for effective control of the economy. Such statements would also serve to create an informed public as to profits, prices, wages, etc., and aid management in determining policies with respect to pricing, credit, dividends, and expansion, and the like. Although the fluctuations of the dollar is a well-known fact, the material significance of it as a problem in accounting is less attested to. Accurate estimates are difficult, but there is sufficient evidence as to the significance of the problem to warrant further study.

The use of current values or anticipated replacement costs as a basis for valuations would be a departure from recorded historical costs and would destroy much of the objectivity of accounting. In contrast, the adjustment of historical dollar costs by restating these costs in current dollars of equivalent purchasing power as measured by a general price index would be more acceptable. This method differs from conventional accounting only in that it recognizes changes in the amortization of costs and the determination of periodic income. Since only past changes are reflected, this method is independent of possible future price fluctuations, either upward or downward.

The most widely urged objection to the use of general price indexes as a means of adjustment is their alleged inaccuracy. The Committee believes, however, that the errors
resulting from the use of such an index are relatively unimportant where substantial changes in the price level are involved. The practical limitations to this method arise in the area of adjustments for very small changes in the general price level and for adjustments over a very long period of time. These practical limitations, in the opinion of the Committee, would not invalidate their use.

For want of a better statistic, the Committee feels the wholesale price index of the Bureau of Labor Statistics would adequately serve for experimental purposes. It is believed that a better index could be developed, and would be, if the need became apparent. That this, or any other, index provides generally acceptable indications of fact is demonstrated by their increasing adoption as bases for wage payment contracts.

The Committee feels that experimentation may demonstrate that the effects of price level changes are of sufficient importance to merit a more comprehensive treatment. Because of this, they advocate revealing the extent of the problem by means of supplementary statements. From this, it follows that these statements must be prepared on a consistent basis. Items in the two supplementary reports—income statement and balance sheet—must be adjusted in a similar manner. Then, too, the primary and supplementary statements should be reconciled with accompanying comments and explanations.

To conclude, it is the judgement of the Committee that
the time has come to give adjusted dollar statements a thorough test. These statements should now be supplementary to financial statements based on historical cost. The following premises should apply: (1) A general price index should be used because the supplementary statements are intended to restate historical costs to reflect changes in the value of the dollar. (2) The adjustments should be comprehensive in scope to reflect the changes in each item in the income statement and balance sheet to the extent appropriate. (3) The two supplementary statements should be fully reconciled and accompanied by explanations as to their nature, usefulness, and limitations.
*CHAPTER IV*

THE PRESENT POSITION
A. HISTORICAL DOLLAR COSTS

Despite the results of numerous conscientious studies showing many varied, and seemingly sound, methods of providing for price-level adjustments, few persons appear to have shown much enthusiasm about adopting any of them. According to one author, Carmen G. Blough, this probably signifies that businessmen, in general, are not ready to adopt an entirely different concept of income than that which is already accepted by society—the concept to historical costs.56

The matching of costs and revenues, which is basic to accounting, affects every transaction in which profit and loss is determined. To the farmer who sells for $1,500 land he bought ten years ago for $1,000, he has made a $500 profit. Similarly, a man who invested $500 in corporate shares and sells them for $700 some years later figures that he has made a $200 profit. The fact that he may not be able to buy as much with the $700 he now has, as compared to what he could have purchased with the $500 had he not invested it, does not seem to bother him.

Maybe these people are wrong! The most important thing to them is that they have made a monetary profit, although in reality they may have suffered a purchasing power loss. As concluded by Mr. Blough, it would take a pretty severe jolt to shift the thinking of the American public away from assuming their dollar as being anything but stable.57

But what is this "stable dollar assumption?" In accounting, it is assumed that the monetary unit is of constant dimensions; that is, that the purchasing power of the dollar remains unchanged. This assumption is followed in spite of the very evident fact that the purchasing power of the dollar has changed. Although this assumption is contrary to fact, the majority of accountants have felt no compulsion to modify accounting methods or procedures. The reluctance to make allowances for price-level variations is not the result of unawareness on the part of the accounting profession. Rather, it is the belief that these changes have been gradual and are not material enough to invalidate the assumption.58

Many argue, as was previously seen, that conventional accounting should be revised to reflect the seemingly evident fact that price fluctuations do tend to misstate the economic significance of financial statements. It should be re-emphasized here that many balk at changing existing accounting con-

58 Finney and Miller, p. 623.
ventions. Although fixed assets are generally carried on the books at cost, plus improvements and minus depreciation, this figure may admittedly be higher or lower than the current economic value. The practice by which items are carried at figures which are sometimes different from their true economic value is the result of what is known as an accounting convention.

The individual items that make up the fixed asset, inventory, and other accounts are not appraised separately each year. For example, in the case of fixed assets, depreciation is taken on each asset and charged to expense for that period. This depreciation is then deducted from the recorded value of the asset to which it applies to determine the conventional value of the asset. To the extent that this is done today, accounting is said to follow the monetary concept of income. In other terms, it is called "dollar accounting." 59

B. A CASE FOR CONVENTIONAL ACCOUNTING

Because I have given what might be considered extensive coverage to those who advocate changing existing accounting procedures, I feel that it is only fair to give some consideration to the supporters of conventional accounting. It has been my experience to find that the arguments favoring

59 Ibid., p. 626.
conventional accounting are quite numerous. Because most of them are self-explanatory, to cover them in detail would be unnecessary. I hope that the following list will suffice. This author does not intend that the following list be inclusive of all the arguments favoring present-day accounting, but I do feel that I have touched upon the major ones.

1. The prevailing concepts and practices have worked well over the years and, as a result, conventional statements are now widely used and respected.

2. During most periods, the change in the value of money has been so gradual that it does not affect the financial statements materially.

3. Although the upward movement of prices has produced awareness of the instability of the dollar, people do not seem to desire any departure from historical cost.

4. There is lack of agreement as to the methods by which any adjustments could be made.

5. Price-level adjustments would result in numerous complications because current dollar adjustments would be called for whenever transactions involving asset expenditures of different periods are performed.

6. Some accountants contend that there are few hist-

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ical dollars in the current statements to begin with. The few historical dollars that are in the statements are found mostly in the fixed asset group, and management has a tendency to use conservative estimates in determining the useful lives of these assets. Amounts in non-depreciable assets, of course, do not enter into the determination of periodic net income.

7. Because of the rapidly changing techniques in production, a large portion of the fixed assets of a business have been recently acquired and require little or no adjustment.

8. Material misstatement of assets may result if asset values are adjusted by a price-level index. This is possible, in many instances, because the difference between historical costs and current costs involve more than the change in the price level.

9. Changes in accounting procedure would necessitate a complete overhaul of the tax system since the stable dollar assumption is deeply imbedded in tax policy and practice.

10. A vast body of common and statutory law and legal precedent, innumerable contractual and business relationships, and many regulatory provisions are presently founded on existing accounting principles. To change conventional accounting procedures would almost certainly call for a revision of numerous statutes and contracts.

11. The effect of asset revaluations might lead to a
drop in the price of the firms' stock because the stockholders may fear that the substituted values will lead to lower distributable future earnings.

12. Because of the nature of the modern corporation, the relationship existing between management and the stockholders is one of stewardship. One function of accounting is to provide a mechanism by which the results of this stewardship may be reported. If the financial reports are clouded with price-level adjustments, the consequences of management's decisions may be hidden and the accountability function hindered.

13. It is the function of accounting to record expenditures and related expense items in historical cost dollars. Because there are many different ways to adjust these figures, adherence to historical cost data is consistent and allows the statement readers to adjust the figures as they see fit.

C. STUDY GROUP ON BUSINESS INCOME

The current approach to the problem, as most accountants see it, is reflected in the findings of the following study. In 1947, the American Institute of Accountants and the Rockefeller Foundation jointly financed a project known as the Study Group on Business Income. This group, composed of
accountants, lawyers, and economists, devoted a large part of its time to the problem of price-level adjustments in income determination. The following is a result of that study.

Net gain, the excess of revenues over costs, is ideally measured when the standards of comparison are as identical as possible. To measure costs in terms of a monetary unit of changing purchasing power (historical cost) is favored because of its ease of application and wide acceptance. To measure costs in units of equal purchasing power would obviously be more useful, but the problem of adopting this concept into current practice arises. The problem of implementation arises because either the amounts stated in the first case (historical cost assumption) must be adjusted for changes in the price level, or else the replacement costs of what has been consumed must be used.

With certain exceptions, such as the use of lifo, the past monetary, or historical cost concept, has prevailed as the basis of measuring income. This concept is justified largely on the view that the monetary unit may be regarded as being reasonably stable. The Business Income Study Group concluded, therefore, that a change in the accounting procedures to charge operations on any basis other than cost should not be undertaken. It was agreed, however, that the net income disclosed by conventional methods did make pos-

American Institute of Accountants, pp. 103-5.
sible misleading inferences. 62

In spite of noted defects, the Study Group agreed that the primary statements of income should continue to be made on the bases now commonly accepted. The Study Group did go one step further by stating that supplementary statements based on units of substantially the same purchasing power would be significant and useful for many of the purposes that the present statements are now used. Although the problems of having both kinds of statements would present difficulties, the benefits may be worth the extra effort. 63

62 Herrick, p. 53.

63 American Institute of Accountants, p. 105.
*CHAPTER V*

CONCLUSION
At the present time, uniform-dollar figures may be used only for managerial purposes and for informal reports to stockholders, employees, and for similar purposes. They are not at present acceptable for use in formal reports or for income tax purposes. Many feel that their most important use would be in computing taxable income. Thus far, the government has refused to recognize for tax purposes any procedure not generally accepted for accounting purposes. 64

In Chapter 9 of Accounting Research Bulletin Number 43, the Committee on Accounting Procedure of the American Institute of Certified Public Accountants concluded that no basic change in present-day accounting procedures was practicable or desirable. The Committee clearly recognized the impact of inflation on accounting and gave its full support to the use of supplementary schedules or explanations to disclose the effects of inflation on the reported balance of financial statements. 65

It is my opinion that, as a result of inflation, discrepancies between the monetary and the real results of business operations have become obvious. On one point, there seems to be unanimous agreement; namely, that during periods of significant price level changes, the conventional financial

64 Jones, Effects of Price-Level Changes, p. 137

65 Grady, p. 319.
statements lose some of their economic significance they have during periods of price stability. This is to say that during periods of price instability the customary financial statements will not satisfy all the needs for economic information.

Broadly speaking, there are two courses of action. One is to reconcile the amounts and present both the monetary and the economic results in one set of statements. The other is to prepare supplementary statements to show the economic results of operations and have the conventional statements present the results in historical terms. While the first suggestion is preferable, it is also the more difficult, both in terms of actual transition and in terms of convincing the public and the businessmen that it should be done.

This leaves us with the second alternative. For anyone having access to the detailed figures, preparing supplementary statements seems to be a comparatively simple task. It is to be emphasized, however, that the adjusted statements are not to serve as substitutes for the historical ones. The supplementary statements merely provide interesting information not found in conventional statements, but further evaluation of the results is needed before we know how useful that information may be.
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BOOKS


PERIODICALS

