ACCOUNTING FOR BUSINESS INCOME UNDER INFLATION: CURRENT ISSUES AND VIEWS IN THE UNITED STATES*

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To adjust business accounting for inflation, one current proposal is to convert all dollar figures in existing financial statements to units of fixed general purchasing power. A widely offered alternative is to retain the dollar units but replace the historical-cost figures by current values. The two alternatives would yield very different results. After reviewing these and variant proposals, the analysis concentrates on certain major issues: the unit of measurement; the treatment of capital gains; the concept of capital maintenance; and the treatment of changes in the purchasing power of debt. Current value accounting would not correct for changes in the general price level and would involve far more difficult problems of concept and measurement than general purchasing power accounting. The latter is therefore preferable.

1. INTRODUCTION

As its title indicates, the present paper concentrates on the financial statements of business in the United States. I review the discussion going on among accountants, financial executives, and the others concerned, of how to adapt business accounting and reporting to inflation. As might be expected, however, many of the questions raised apply also to accounting for the income and wealth of families and other nonbusiness entities, and in countries other than the United States. And they apply, as well, to some of the adjustments for price change made—or not made—in the official national accounts.

In recent years, with the discussion of inflation accounting in the U.S.—as elsewhere—more intense than ever before, helpful calculations illustrating the various estimates of business income and net worth that would emerge from one or another decision or compromise on the various issues have been accumulating. What is worrisome, however, is the extension of the discussion beyond the topic of inflation accounting *per se*. It is not being limited to the application, to conventional financial statements, of a correction for the decline in the purchasing power of the accepted unit of reckoning, the dollar. Now embraced and subject to questioning are other "generally accepted accounting principles" (GAAP), in accordance with which conventional statements are prepared. Differences of opinion about these "generally accepted" principles were by no means dormant before inflation became serious. However, the issues have become more acute in its presence, especially (though not entirely) because of

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the predilection in many quarters towards "current value accounting" as the solution of the inflation accounting problem. The purposes to be served by financial accounting and reporting, and with regard to these purposes, the degree to which financial statements can at the same time be made more relevant yet still remain reasonably reliable, understandable by their users, and also conservative—such fundamental matters have come under closer scrutiny.

The effort to reach a consensus on inflation accounting is proceeding at a stronger pace than some years ago, as I have noted. But if its success requires a resolution of many of the fundamental issues opened up by an examination of the conceptual framework of accounting, doubt arises whether it will soon be attained. Whether this resolution is necessary to meet the problem posed by inflation is itself a question, however. The distorting effects of inflation are serious. The need to deal with them is urgent. Is it worthwhile—considering the cost of delay—to take the time to come to terms on many other issues; and—as solutions involving current values would require—to burden management with the task of making the estimates that would necessarily remain rough and subjective even if a large collection of price and other data were amassed?

As the reader will have gathered, I do not think so. True, a change in GAAP aimed solely at correcting the accounts for decline in the purchasing power of money cannot help but raise questions about some of the other accounting principles. But to deal reasonably well with these questions does not require rewriting the entire constitution that underlies financial accounting and reporting. We need not neglect altogether the effects of inflation on financial statements while the nature and advisability of steps to provide a comprehensive reformulation of GAAP are debated.

2. Generally Accepted Accounting Principles: the Current Situation

Before sketching the developments in the United States that have brought us to this point, it is well to recall the principles to which currently published financial statements are expected to conform and which therefore guide their preparation and certification. Of prime importance among these principles, in the present connection, are use of the dollar as the unit of reckoning, and devotion to historical costs. Also involved in the discussion of inflation accounting, however, are the principles of postponing the recognition of operating revenues and expenses and non-operating gains and losses until they are realized, and of including realized gains and losses in current net income. It therefore becomes necessary to consider these principles as well.

It should be understood that GAAP allows certain exceptions, some of which will be mentioned, and (what is not the same thing) for a rather considerable degree of latitude—too considerable in some views—in the choice of the principles to be applied when they conflict, as they will on occasion. Further, GAAP is not fixed in time, which is why I specify "the current situation." Changes in the relative importance of the objectives to be served by financial

statements may alter the trade-offs among the objectives and lead to changes in GAAP. And the principles are eventually adapted to important general changes in circumstances, such as the vastly increased importance of leases and pension systems. Inflation is, of course, the case before us.

The income reported in financial statements conforming to GAAP reflects the end result of a calculation involving a mixture of current values and historical costs, measured in dollars subject to change in purchasing power. All changes in prices (with the exception, noted below, of gains never realized) are sooner or later reflected in revenues and costs and gains and losses, and thus also in reported net income. More specifically, when prices are generally rising, certain effects follow: (1) The net income reported for a period is higher than it otherwise would be because of the lag of historical costs between the time of acquisition and the time of sale or use of goods sold or plant and equipment consumed through wear and tear and obsolescence. In other words, net income is overstated because the portion of revenue required to provide for the maintenance of capital is understated. (2) Net income tends to rise from one period to another at a more rapid rate than it would were price levels stable. Growth in "real income"—income in terms of purchasing power—is less rapid than growth in money income. (3) Reported net income reflects changes in the prices of inputs and outputs relative to the general price level, as well as changes in the general price level itself. When changes in relative prices are in a firm's favor, its net income will tend to rise more than it otherwise would; when in its disfavor, reported net income will tend to rise less.

What changes in GAAP are required to deal with inflation, in view of these effects?

The lag in historical costs requires that these costs be updated. But updated by what—an index of the general price level, or indexes of the particular costs concerned? Involved here is a question long familiar to economists. Is income to be measured by what can be spent after providing for the maintenance of financial capital or of physical capital? Under GAAP, it is the former that is "accepted" as the appropriate definition. An increase in the prices of inventory or plant and equipment, then, would be counted as adding to the capital invested in them, either immediately or later when realized. (The major exception under GAAP occurs when the "last-in-first-out" [LIFO] procedure is used for inventory accounting. More about this in a later section.)

To correct for the decline in purchasing power requires a shift from dollars to units of fixed purchasing power. But purchasing power over what? Should we substitute for the dollar unit a unit of fixed general purchasing power or a unit of fixed specific purchasing power? Specific purchasing power measures real income in terms of the bundle of goods and services on which the income of a particular firm is spent, rather than of the bundle of goods and services on which income in general is spent.

The question of "realization" troubles accountants more than it does economists, because accountants have had more and closer experience with optimistic and sometimes even shady businessmen. The issue here is whether unrealized revenues and expenses or gains and losses are to be recognized; and if so, how they are to be determined and by whom, and how presented in the

financial statements. Under GAAP, because accountants prefer conservative and also objective and therefore verifiable estimates, these unrealized items are excluded. The rule is not to enter them in the accounts until they are finally realized, as by sale. A rise in the market price of an asset (for example, land) that is not sold or used up in current production will not be counted as income. Exceptions, made for consistency with the practice of accrual accounting and the doctrine of conservatism, apply mainly to expenses and losses. Inventories may be valued at the lower of cost or market, for example. The usual provisions for reserves against depreciation and obsolescence, bad debts and self-insurance, can also be thought of as exceptions; or, alternatively, as realized "by use". Occasionally, write-downs—but not write-ups—of assets will be made even when not realized through a transaction. The realization question is raised about changes in the real values not only of tangible assets but also of monetary assets and liabilities. When the general price level goes up, these gains or losses can be very substantial. Whether they may be viewed as realized and taken into the calculation of income, or as unrealized and put aside, is therefore an important question.

The final question we raise concerns the distinction made between operating and non-operating, or normal and abnormal, business events. The measure of operating income is presumed (on grounds open to some question, however) to provide an index of a firm's long-term earning capacity. This is the old question of the place of capital gains, especially those resulting from price and interest rate changes, in the determination of current income. Are realized capital gains to be treated as part of current income (although segregated in the income statements) as is the practice now under GAAP; or handled as direct adjustments of capital, as was the accepted practice some decades ago? And what of unrealized capital gains, if these are taken into the accounts?

3. Developments to Date

Attention to the problem posed for the financial accounting and reporting of business firms by a persistently rising general price level became really serious in the United States only late in 1973, when the rate of inflation reached "double-digit" levels.[1] Early in 1974 a "discussion memorandum" on the subject was published by the Financial Accounting Standards Board, a non-governmental body set up by the American Institute of Certified Public Accountants with the participation of other interested groups and the approval of the official Securities and Exchange Commission. By the end of 1974, after digesting the many oral and written reactions to the memorandum, the FASB felt ready to state, in an "exposure draft" circulated for final review, the standard to which it was leaning.

The FASB's proposal to meet the problem was relatively simple and aimed directly at the point in question. The idea was to make only one change in the

[1]A brief sketch of developments prior to 1973 is given in my paper, "Toward Rational Accounting in an Era of Unstable Money, 1936–1976." See the bibliographical note below.

accounting principles generally accepted and followed in the preparation of the financial statements of business—a shift in the unit of reckoning—and one that could be implemented with reasonable dispatch and at modest expense. Under the proposed standard, business corporations would be required to supplement the financial reports they were already making in terms of dollars varying in purchasing power from year to year, with a parallel set of reports identical in all respects except that they were to be expressed in units of constant general purchasing power.

For monetary items, such as cash and debt in the balance sheet, and sales receipts and interest costs in the income account, this would mean merely dividing the amounts reported in the usual financial statements of a given year by the ratio of the given-year index of the general price level to the index of the year in terms of which the purchasing power unit was defined. It would be a bit more of a nuisance—though less later than at the outset—to convert to purchasing power units the reported historical costs of non-monetary items, such as plant and equipment and inventories and the current charges associated with them. These, having been acquired at various times in the past, were at different price levels. The year of each acquisition would have to be identified and the adjustment to base-year price levels of each vintage made accordingly. But this task would not be unduly complicated; and the necessary data had to be available in existing accounting records. As for the choice of the index of the general price level, only the Consumer Price Index and the GNP Implicit Price Deflator could be regarded as serious candidates. The FASB chose the GNP deflator.

Quite explicitly, then, the FASB was deciding against the proposal, often discussed in the U.S. and elsewhere, to adjust to the fact of inflation by converting historical costs to some sort of current values, with or without a further conversion of current values to units of fixed general purchasing power. The Board recognized that a shift to current values raised serious questions about the choice among, and reliability of, the various possible measures of current value, and involved also many other contentious questions about generally accepted accounting principles that went well beyond the immediate problem posed by inflation. These questions, the Board felt, should be set aside for separate (and later) consideration.

With the FASB's proposal out and, if approved, slated to become effective in financial statements for fiscal years beginning as early as January 1, 1976, the question of inflation accounting could no longer be treated as an academic matter. The figures that might be expected from application of the FASB's approach to financial reporting were therefore looked at more closely than before.

One lesson was that companies and financial analysts had difficulty in adapting their thinking to the new unit of account. As the FASB said later, the companies and analysts did not seem to understand how to use the data adjusted for inflation according to its proposal. But, second, it also appeared that many of those who thought they could make sense of the figures found the results surprising and disturbing. They were aware of the inflationary effect of a rising general price level on replacement costs, but had tended to overlook its opposite

effect on the purchasing power of long-term debt, which had come to bulk relatively large in many balance sheets during the post-war period. And it was felt, further, that the treatment of the monetary items proposed by the FASB, particularly of gains from the reduction in the purchasing power of this debt, could be interpreted as more than just a shift in the unit of reckoning—as, in fact, a departure from the general rule of not recognizing gains until realized.

In any case, critics of the FASB's proposed standard, with different ideas on how, or how far, or even whether, the problem posed by inflation should be met, and even those generally in favor of the new standard but questioning its details, sharpened their criticisms and protests. Many renewed their arguments for making allowance for inflation by substituting for historical costs their current money values or costs, rather than the original costs in general purchasing power units. But some would do this only for some items, such as depreciation and obsolescence charges and cost of goods sold, while others would substitute current values for all items. Of the latter, some would take also a second step and convert the current values, or their net change, to values in purchasing power units; others would not. As for those who agreed on an adjustment to purchasing power, either by itself or after the conversion to current values, some questioned whether the line between monetary and non-monetary items had been properly drawn, and whether the supplementary set of statements needed to be as detailed as the primary statements. And there were some, even, who believed that supplementary financial statements adjusted for inflation were unnecessary. In their view, sophisticated investors and financial analysts who could understand the adjusted figures had been making their own adjustments and did not need the supplementary figures; and those not so sophisticated had more than enough trouble making sense of the existing financial statements and could be expected to continue to depend on the others for advice. Opinions, it is clear, differed very widely.

In the midst of all this, in August 1975, the Securities and Exchange Commission entered the arena with a limited current-value proposal of its own. During 1973 and 1974 the SEC had been urging the disclosure, to be made in notes to the usual financial statements, of replacement costs of inventories and then also of plant and equipment, and of withdrawals from inventory and charges for depreciation and obsolescence. But to what turned out to be only "jawboning" by the SEC, there was little response. Now, with the FASB's proposed standard—about the priority of which the SEC apparently had its reservations—in the offing, the SEC proposed a regulation to require (not merely urge) such replacement cost disclosure by all the large corporations under the SEC's jurisdiction. First, the SEC's requirement would cover only the items specified, not all, in the income account and balance sheet. Second, the SEC asked for current replacement cost, not reproduction cost. And third, no deflation by an index of the general price level was required or even recommended. The SEC stated only that when implementing its rule, "some registrants may wish to use data regarding changes in the general price level as part of the analysis of reasons for changes in replacement cost." In effect, the SEC was supporting the position that income was properly measured after provision for

the maintenance of physical capital: any increase in replacement values per physical unit of inventory or plant and equipment would be counted as raising unit costs, but not as providing gains from holding these assets.

With the weather turned so harsh, in November 1975 the FASB decided to postpone the proposed effective date of its own standard. Time was needed, the Board said, for study of the many letters of comment received on the exposure draft and of the results it expected to obtain from an application—more extensive and detailed than hitherto made—of its proposed standard to the financial statements of a sample of large corporations for recent years.

Unlike the SEC's earlier proposals on the subject, the Commission's new proposal was not still-born. In March 1976 the replacement cost requirement became official, and effective with end-of-1976 financial statements. It was not surprising that soon after, in June 1976, the FASB announced its decision to postpone its 1974 proposal indefinitely. By way of explanation the Board reported the lack of understanding of financial data adjusted for inflation, already mentioned, and its resultant feeling that the cost of implementation did not (or did not yet) appear to be warranted. The Board also stated, however, that it had not itself yet come to a final conclusion about the merits of its proposal and—its mind changed—that the subject of inflation accounting would be considered within the FASB's broader project, already under way, on a conceptual framework for financial accounting and reporting. In December 1976, the FASB published a long discussion memorandum setting forth some of the major issues related to that broad subject, including those particularly pertinent to our present concern, with a promise of further memoranda on other issues at a later time.

Accompanying the discussion memorandum was a separate statement on the Board's tentative conclusions concerning the objectives, of financial statements of business enterprises, at which the conceptual framework should be aimed. Also issued at the same time was a booklet providing a "capsulized" view of the preceding documents, to which some remarks were added under the heading of "The Next Step?". These hinted that the process of formulating new standards to cope with inflation (among other things) and learning to live with the standards before they became "official" requirements for financial accounting and reporting, might stretch out well into the future—the implications of which will concern us later.

During 1976, in the meanwhile, many meetings of accountants, financial officers and economists had been devoted to the procedures and data involved in meeting the now official—and difficult—SEC requirements. In the case of plant and equipment, the SEC had made emphatic, the requirements were to report the cost of replacing existing capacity, which could be obsolescent, with equivalent capacity of modern design, not to report the cost of reproducing existing plant and equipment. The SEC itself felt compelled to issue several Staff Accounting Bulletins in order to assist accountants and financial executives to interpret and meet the new disclosure requirements. The complications involved became evident as these requirements were studied, and protests against the regulation mounted. But the SEC held fast, and during the Spring of this year annual reports and the more detailed 10K reports to the SEC providing such

information have made their appearance. Usually, also, these reports have contained warnings about the difficulty of interpreting the replacement cost data—warnings often carried to the point of stating that the data were virtually meaningless and had been provided only at the SEC's insistence.

Noteworthy also is the "experiment" gotten under way early in 1977 by a Task Force of the AICPA, the results of which are to feed into the material to be considered by the FASB. For the experiment, as reported in April, the Task Force designed four "models" to accommodate what it felt were the major lines of thinking on concepts and measurement and their implications for the adaptation of financial accounting and reporting to an era of inflation. The models are to be applied by some thirty or more large corporations to their respective financial statements for 1975 and 1976, with such additional variations within each model as the companies believe desirable. In addition, of course, there will be the financial statements prepared in conformity with present GAAP. The experimental applications are due to be ready in October of this year.

To bring the story up to date: Compilations and preliminary examinations of the results of the SEC's requirements have begun to appear; in May the FASB completed and published its research report on financial statements in units of general purchasing power; written comments on the FASB's memorandum on the conceptual framework have been accumulating; hearings on the subject originally scheduled for one meeting in June, 1977, have been postponed to two meetings, one in August, 1977, and the other in January, 1978, with the latter date devoted particularly to the problem of inflation accounting; and the results of the AICPA's experiment should presumably be available (although barely, I would guess, considering the time required for collation and at least minimal analysis) in time for discussion at the FASB's meeting in January, 1978.[2]

4. The Variety of Inflation Accounting Models

The AICPA's Task Force does not presume that its models have equal claims as candidates for acceptance. Nor does it appear that the choice among them and their variations will hinge on how the results look in relation to one another, though it is hard to believe that comparison of the results will not play some role in the preferences expressed. However, the results will reflect the outcome of a number of the more important proposals to which I have alluded and now need to specify. For this purpose it is sufficient to note the chief distinctive characteristics of the models, and mention how they differ in certain major respects from the "illustrations" provided by the FASB in an appendix to its discussion memorandum.

[2]Lack of space has precluded attention to certain proposals to deal with inflation made by the Cost Accounting Standards Board, established by the U.S. Congress about five years ago to set accounting standards for Federal Government procurement contracts. The standard that finally emerged in June 1976, effective October 1, 1976, will be discussed (along with other CASB standards) at an "evaluation conference" to be held in October 1977.

For a brief summary and critique of the proposals and the new standard, see the paper mentioned earlier. To what is said there, I should add the following: The CASB standard on inflation cannot be judged fairly without reference to its other cost accounting standards as well as to the Department of Defense's "guidelines for the profit standard" in defense procurement contracts.

The Task Force's Model A is essentially a set of financial statements made in accordance with the FASB's general purchasing power proposal, modified and condensed somewhat to meet some of the criticisms leveled at that proposal.

Model B goes to current values in calculating net income, but—as with the SEC's requirement—only for the cost of goods sold (which is to be on a LIFO basis) and charges for depreciation and obsolescence (using lower of reproduction and replacement cost). As a result, reported net income under Model B will be lower than the net income reported under GAAP by the difference between historical cost and current cost for these two items. (To the extent that LIFO is already used for inventories, as it may be under GAAP, the calculation of net income already uses the current cost of goods sold.) Increase in the unit value of the corresponding assets, inventory and plant and equipment, is not counted as income: the concept of physical capital maintenance controls the determination of income. Were the LIFO procedure applied to accounting for plant and equipment, as it is to be for inventory, the change in stockholders' equity would also be lower by the difference between historical and current cost of depreciation and obsolescence. But it is a peculiarity of the model that plant and equipment continue to be valued at their historical cost; the year's excess of current-cost over historical-cost depreciation is credited to a special equity account entitled "Accumulated Current Depreciation;" and the excess is eventually transferred to retained earnings when the depreciable fixed assets to which it relates are sold or retired, although it was not reported as earnings in the income statement.

Model C is closer to a full current value basis than Model B, and the current values are estimated somewhat differently. In the balance sheet, securities and land, as well as inventories and buildings and equipment, are stated in current values. However, as under GAAP, long-term debt is at par rather than current value; changes in the market value of debt are recognized only when the debt is liquidated at the market price. All value changes are excluded in calculating net income, which therefore differs from GAAP net income essentially as does Model B net income. Value changes are accumulated in the balance sheet under the headings of "Unrealized Value Changes" and "Retained Realized Value Changes," and appear as part of stockholders' equity along with retained operating income and contributed capital.[3] General price level changes are not recognized as such.

Model D goes still further to a current value basis in that long-term debt is reported in the balance sheet at market value. However, no changes in value are considered to affect net income. They are listed, along with the net income resulting from ordinary operations (which include some unusual transactions and events), in a special statement of changes in stockholders' equity, and in supporting schedules. An interesting inclusion in this statement is an estimate of "the amount required to recognize the impact on stockholders' equity of increase in the general price level during the year." In effect, the difference

[3]Except for presentation, the Task Force states, the model resembles in many respects the models proposed in the United Kingdom by the Chartered Accountants Exposure Draft 18 on "Current Cost Accounting."

between this amount and the reported sum of the value changes is the gain or loss due to value changes greater or less than the rise in the general price level. Inclusion of this estimate of the impact of general inflation is the closest the model comes to recognizing the decline in the purchasing power of the dollar units in which the financial statements are expressed.

The AICPA's current-value models (C and D) and the corresponding illustrations provided by the FASB differ in a number of respects. Two of these are important enough to be noted here, for they reveal how wide is the variety of models offered as deserving of consideration. First, the FASB includes purchasing power gains on monetary items and holding gains on tangible assets in net earnings (distinguishing them from earnings from operations). These value changes, realized or unrealized, are not credited directly to capital, as in the AICPA's models. Second, the FASB shows what the current value statements would look like after conversion of the money units in which they are expressed to units of general purchasing power.

5. The Unit of Measurement

The problem of inflation accounting stems from the fact that the money units in which the accounts are kept are unstable in the sense that they decline in general purchasing power—in real value—as the general price level rises. The problem is exacerbated by the lag between historical cost and current cost, but it would exist even if the lag were of trivial importance or entirely absent. The solution requires deflation of the dollar figures, both historical cost (taking appropriate account of the dates to which the historical cost figures refer) and current cost or value, thus converting them into units of fixed general purchasing power.

But many, probably most, accountants and businessmen seem to think of the problem of inflation accounting as stemming from the fact that historical costs lag behind current costs and prices when price levels are rising. They see the solution as one of correcting for this lag. The historical cost dollar figures must, in other words, be inflated rather than deflated, and brought up to or in line with the current level of prices. This solution would serve also to provide financial statements that conform to established habits. The unit of measurement would continue to be the customary dollar unit; there would be no need to deal with an artificial or imaginary unit of fixed purchasing power.

Resistance to the idea of units of general purchasing power, and a correspondingly strong inclination towards current values in dollar terms, is clear. It is evident in the reactions to the FASB's exposure draft on general purchasing power accounting. It led the FASB, in its discussion memorandum on the conceptual framework, to raise the question whether current value accounting is "a foregone conclusion". More recently, it is indicated by the models chosen by the AICPA to illustrate the varieties of current thinking.

Why the resistance to general purchasing power units and the partiality towards current values in dollar terms, in the dialogue over inflation accounting? The idea of converting historical to current cost is not necessarily incompatible,

of course, with the idea of purchasing power units, since a second step can be taken to pass from the current dollar units to the purchasing power units, as is suggested in the FASB's illustrations. However, this is infrequent among the proposals being seriously considered.

Even economists might appreciate the trouble people have with a unit of measurement that is new to them, if they were to take a moment to recall their own difficulties with the metric system. Yet all that is required to switch from yards to meters is conversion merely by a fixed ratio, not by the changing ratio required in the conversion of dollar values to purchasing power units. Economists find it easy to think in terms of units of general purchasing power because they have been trained to do so. And economists are comfortable with the GNP implicit price deflator, which is used to convert dollars to purchasing power units, because they know its derivation and understand the significance of the words with which this measure of the general price level is denoted. These words—"gross," "implicit," and "deflator," if not also "national" and "product"—must often be puzzling to the layman.[4] Nor would the layman's plight be eased by the proposal in the FASB's exposure draft to "roll forward" the purchasing power financial statements from one year to another—that is, to shift the base period annually to the current year's last quarter, instead of sticking to a fixed base, as do most government statistics.

It is likely that many members of the general public have become fairly familiar with such measures as those of real wages. But these are almost invariably presented in the press in terms of changes (as in the AICPA's Model D) rather than base-year prices. The occasional reports of real wages, and other such measures as those of real GNP, have not accustomed people to think in terms of constant purchasing power units. The stress of daily life is always upon money units. Business is done in current dollars. What people see, pay, receive, are current prices in dollars, not units of general purchasing power. Indeed, to most people, inflation means rising prices of what they buy and have to pay for. When galloping inflation forces people to abandon the units in which they have been making their calculations, their recourse is to the stabler money of other countries.

Perhaps the idea of purchasing power units could be understood more readily by people were it applied to their own income and its command over the particular goods and services they purchase. In any case, the question raised earlier, "Which purchasing power?" must be answered.

[4]This is one reason why the Consumer Price Index might be better than the GNP deflator as the measure of the general price level. The CPI has also the advantage that it is not subject to revision (at least in a way that would require "prior period" adjustments), as is the GNP deflator. On the other hand, the GNP deflator is more comprehensive; it covers the prices of capital goods as well as of consumption goods, and of all consumption goods, not only those consumed by urban wage-earners and clerical workers. This is why the FASB chose it. Even the forthcoming broadened CPI, covering consumers now omitted, will be less comprehensive than the GNP deflator.

The Department of Commerce now also publishes a "fixed-weighted price index" for GNP, using 1972 weights. It differs only slightly from the GNP implicit price deflator, but is conceptually preferable to the latter as a measure of the general purchasing power of money. Its use for that purpose would also lessen the problem mentioned in the text above. The fixed-weighted index is available only beginning with 1958, but it could be extended further back without much trouble.

The notion of units of purchasing power specific to the expenditure patterns of particular groups appears most often in discussions of the real income of the aged, the poor, or some other social group, when the objective is to maintain or raise their standard of living in terms of the goods and services normally consumed by the group. But the idea of units of specific purchasing power is not entirely absent from the inflation accounting literature. Indeed, the definition of real net income as what can be spent after provision for the maintenance of physical capital is closely related to the idea of specific purchasing power. Here it may be sufficient to underscore the fact that a price index tailored to the expenditure pattern of a particular group is not a good measure of inflation. What it measures is a combination of inflation—change in the general price level—and the net up or down change in the relative prices of the goods and services bought by the group. The relative prices of concern to different industries, and even firms within industries, are bound to change at different rates as demand and supply conditions vary. The price indexes specific to each will therefore also change at different rates. And this will be so even when inflation is entirely absent, though inflation may contribute to the forces making for relative price change. What these relative price changes have been (and may be expected to be) are, like many other kinds of information, relevant to the decisions of businessmen and investors. But they have nothing to do with the accounting problem with which we are concerned. To eliminate from the accounts the distorting effects of inflation, the unit of measurement must be one of general, not specific, purchasing power.

In view of the obstacles already discussed (and some still to be discussed) to the acceptance of the FASB's general purchasing power proposal, or its slightly modified (and improved) form in the AICPA's Model A—and also the experience to date—we cannot be sanguine that it will be accepted as the solution to the accounting problem caused by inflation. However, before we conclude that it has little chance of being accepted, we should consider the problems posed by the alternative of current value accounting. Going to current value accounting raises questions serious and difficult enough to prevent current accounting from being a "foregone conclusion" or, at least, a conclusion that can be reached reasonably soon.

6. Which Current Value?

When it is proposed that historical costs be replaced by current values—whether or not this is to be followed by the translation of the money units of purchasing power—the question posed above immediately arises. It has two aspects. One concerns the choice of the concept of value; the other, how to measure the current value selected.

Current values can be defined and measured in a variety of ways. The FASB, for example, lists current cost, current exit (market) value, expected exit (net realizable) value, and present value of expected cash flows. And further distinctions are made among historical rate, current rate, and "some other" rate of discount; and between current cost of property, plant and equipment "in kind" (equivalent to current reproduction cost), and current cost of "equivalent

productive capacity" (the SEC's replacement cost). Which current value is to be used for each of the several categories of assets and liabilities,[5] and which suits best the objectives of financial accounting[6] are questions on which opinions differ. This is why the FASB requests respondents to its discussion memorandum on the conceptual framework to answer these questions by checking off their opinions on the "matrix" form provided. (However, what information can be provided by the show of hands, beyond the fact that opinions differ, remains to be seen.)

Obviously, also, serious questions arise on what data to use when one can pick and choose, how to estimate from these data the current value selected, who is to do the estimating, and what information is to be provided in the financial statements to support the estimates.

No economist would object to shifting from historical cost to current values. Indeed, economists were the first to do so. Raymond Goldsmith's balance sheets and the national accounts prepared by the Bureau of Economic Analysis are in current as well as constant prices. But economists are keenly aware of how scanty and rough the information is; they take some comfort in the belief that the various measures of current value tend to converge; they use what is at hand; they are—have to be—content with crude approximations. But the differences among current value concepts and measures make for very real worries by accountants, who want verifiable estimates free from bias.

Consider the kind of information available on the current cost "in kind" of inventories and property, plant and equipment. Members of this Association are well aware of the wide gaps in the available compilations of price and cost data; their uncertain comparability over time because of the quality changes that the compilers are not able to allow for in making up their indexes; and the thorny theoretical, econometric and statistical problems encountered by economists attempting to deal with these quality changes by developing "hedonic" price indexes even to a limited extent.

If this particular variety of current value were to be accepted for use in current value accounting, it would be necessary to extend the price data now available. And to limit the cost of developing and using the data, it would be desirable (as has been suggested) to publish a set of price indexes, recognised as imperfect but generally accepted for the purpose, similar to the set of depreciation rates put together by the Internal Revenue Service in its old *Bulletin F* and its later guidelines to meet an equally difficult problem. The publication would

[5]Receivables, investments in marketable securities, inventories, property, plant, and equipment, and purchased identifiable intangibles, are included in the FASB's list of assets, to which might be added "home-grown" intangibles which may or may not be counted as assets under GAAP. Liabilities are classified into three groups: specified amounts of money payable at specified dates; estimated amounts of money payable at unknown times; and products or services to be delivered in satisfaction of an obligation. The classifications are designed for use in discussing various questions, including some I am passing over. One, for example, is the question whether a liability due at some future date, but on which no interest is charged, should be currently valued at an appropriate discount.

[6]The objectives of relevance, reliability, comparability, timeliness, and understandability, as well as "other", are listed by the FASB. These are drawn from the secondary literature abstracted in an Addendum to Chapter 7 of the discussion memorandum on the conceptual framework.

contain a reasonably detailed set of indexes, classified by industry and type of good, giving the ranges that would be acceptable. Every firm could use this set of conventional price indexes without trying to concoct its own, departing from them only when justification could be given, as in the case of depreciation rates. A precedent is provided by the set of indexes pertaining to department store inventories, regularly published by the BLS and acceptable by the IRS for LIFO. The indexes developed by some industry groups and a few individual companies to meet the requirements of the SEC may have added something useful to what is already given in government sources. But what is now available marks only a beginning in the compilation needed.[7]

Consider, next, the difficulties encountered in determining the current value of existing plant and equipment by turning to the current cost of equivalent productive capacity, as the SEC and others propose. There will be difficulties even when a new machine is identical in all respects except capacity with the old machine that is eventually to be replaced. Capacity and price are not proportionate to one another; doubled capacity is not necessarily at double the price. The SEC found itself compelled to discuss the relationship between size and price, in responding to companies trying to understand its replacement cost requirements, and took refuge in recalling some conventional rules of thumb about the relationship. Yet this is only one of the troubles encountered in pricing equivalent productive capacity. Very frequently the new machine will differ from the old machine not only in capacity, but also in the amount required (per unit of capacity), of labor, maintenance, fuel and power, and even material. These requirements not only may change; they are bound to change as technology improves, and as changes in the relative prices of the various inputs make it desirable to redesign equipment to use increasingly expensive inputs more economically.

The SEC was aware of this problem also, but merely asked registrants to report what consideration, "if any", had been given by them to the related changes in other factor costs. The SEC did not explain how to give this consideration. Even a cursory glance at the 10K's reporting replacement cost, following instructions from the SEC, reveals that many companies offered little more than a caveat to the effect that there would be such related changes and that the associated savings might be large.

The AICPA's Model D would explicitly require the respondent to estimate the future cost savings expected from the replacement of existing with improved capacity. The AICPA even lists "at least four possible ways" of accounting for expected cost savings. However, one of these ways is simply "to ignore them;" the others are not as easy to follow. In principle, of course, the differences among machines of different vintage with regard to the labor, etc., they require per unit of output could be estimated by a careful comparison—when the conditions under which they operate are reasonably similar. But this is easier said than done; and to go further and determine "expected" differences would encounter additional difficulties.

[7]Something like this is emerging in Britain. The Central Statistical Office has already issued the third edition of its "Price Index Numbers for Current Cost Accounting," and a fourth is in preparation.

Another problem in taking the current cost of equivalent productive capacity as the measure of current value arises because of past and projected changes in the demand for the products of the productive capacity. The current value based on some exit value, or an estimate of the discounted expected cash flow, would presumably take both cost and demand into account. But the problem of estimation is complicated. While the FASB lists the discounted cash flow variety of current value in its discussion memorandum, it also makes clear that it hardly expects any company to make a serious effort to use it should current value accounting become accepted. The AICPA is no less pessimistic. In one of its models the current value of plant and equipment that cannot or will not be replaced is to be estimated by the higher of discounted present value of cash flows and current net realizable value. But the AICPA notes that "since determination of discounted present value may be impracticable or impossible, the current net realizable value may be the only available information to use for valuing the asset." And even this value can be estimated only roughly from the scanty market data available.

The complexities encountered in current value accounting may be appreciated also when the relevance, to the measurement of current value, of the charge for depreciation and obsolescence is considered. When a decision to invest in plant and equipment is made, the calculation must allow (among other things) for the loss of value of the new assets as time passes. The annual series of charges for depreciation and obsolescence in effect consists of the estimates, made at the time of the investment, of the declines in current value that are expected to take place each year; and the corresponding net book values, the estimates of each year's current value of the asset. The estimates would admittedly be crude, refinement not usually being worth the trouble, when straight-line or some other simple depreciation formula is used; but this does not alter their nature or purpose. The estimates may hardly be expected to take account of inflation even in an age of inflation; presumably the calculations underlying the investment in plant and equipment are generally made in terms of relative prices, ignoring possible changes in the general price level. The original estimates of future current value, and change in current value, would then require adjustment each year for the year's rise in the general price level, as is proposed in the FASB's model.

But, of course, other things will have happened after the investment was made, besides a rise in the general price level. Are the SEC and those who propose to use replacement costs or discounted present values in effect asking for revisions in the original estimates—revisions made necessary not only by inflation but also by initial ("prior period") errors in the estimate and by subsequent changes in other conditions?

Such questions lead the discussion into a large area of controversy about the theory and factual basis of depreciation and obsolescence. What is the empirical foundation of the IRS's tables of acceptable depreciation rates and the variety of depreciation formulas its regulations allow? Is permitting accelerated depreciation for tax purposes merely an easy way (politically) to allow, in some degree, for inflation? If so, should this allowance be extracted, replacing accelerated depreciation by straight-line depreciation before going to purchasing-power

units? Or is permission to accelerate depreciation simply a way to reduce corporate income tax rates? Or, alternatively, does it bring the estimates actually closer to the realities of depreciation and obsolescence than does the prevailing straight-line depreciation formula? These unsettled questions, which I can only mention, are often discussed (especially by economists),[8] but seldom in connection with the problem of inflation accounting.

Not of negligible importance, in thinking about current value accounting, is the burden that would be imposed on management to provide current value estimates and justify them, should current value accounting become the generally accepted procedure for dealing with inflation. The fact that the burden of compliance with any change in accounting procedure tends to be over-stated by businessmen should not cause us to under-state it.

The great advantage of general purchasing power accounting is the modest demands it makes. Even the kind of current value accounting that would accept simple "indexing" would enlarge the task substantially. If the current values by which historical costs are to be displaced are anything like replacement costs with allowance for savings of other inputs, or discounted value of cash flows, the burden would be multiplied by a substantial factor.

As I have reminded the reader, a decision to invest in any piece of tangible capital involves a judgment whether the value of the item to the firm at least equals its cost. This requires not only assessing the immediate possibilities but also formulating expectations about the future. These will presumably be based on what solid information is available, but this information will never be sufficient. Recourse will be had also to judgments or guesses of all kinds, and these will be influenced, as they must be, by hopes and fears about the future. In small enterprises the calculation may therefore be extremely informal. In large enterprises, it may take the form of detailed justification on paper; but even in this case, the final selection among alternative investment possibilities will seldom be based merely on comparisons of the calculations of their expected payoffs. In any case, what calculation is made will be made internally. About all that will get into the financial accounts released annually, apart from general remarks by the president of the company, will be the costs incurred in making the investment and the depreciation and obsolescence that will be applied to the new assets. No ordinary stockholder will demand or expect a detailed justification of the investment decision.

Yet, to require that management calculate, publish, and be prepared to justify estimated current values, is in effect to demand and expect something of this sort. And not only once, but every year. It goes without saying that businessmen are always watching the course of events as closely as they can. They are always asking themselves whether to enlarge or to contract, whether to replace their capacity with the same or with different capital goods, and so on. But this monitoring is more often rough and ready than detailed and precise; and the results need not be, seldom can be, and even more rarely are, presented even in the remarks attached to the formal financial statements.

[8]Most recently, at a meeting on the measurement of capital held by the Conference on Research in Income and Wealth in Toronto, late in 1976.

7. The Capital-Maintenance Issue

Under GAAP, as mentioned earlier, net income reflects all changes in prices, relative as well as general. There will be lags in the response of expenses to price changes, because the expenses are charged at historical cost, but eventually all the price changes will enter the income statement and affect the net income it reports.

Conversion of the dollars in the accounts into units of general purchasing power will eliminate the changes in the general price level, but not the changes in relative prices. The real values of inventories (except for those under LIFO) and plant and equipment—and also intangibles if they are recorded—as well as the real costs of goods sold and depreciation and obsolescence, will reflect these changes in relative prices. The physical volume of inventories may remain quite constant, for example, yet its real value will be higher or lower than before if the prices of the goods in inventory have risen more or less than the general price level. And this change in value will be included in real net income. In short, real income (after taxes) is defined as the purchasing power available for dividends and net investment after deducting provision for the maintenance of real capital, not for the maintenance of physical capital.

However, some people think of capital in physical terms, when they worry about inflation accounting. They conceive of an enterprise as continuing in the same line of business indefinitely, and maintaining its capital only when its physical capacity to turn out or handle its usual line of products is maintained. They would exclude the effect on income of a change in the relative prices of inventory and plant capacity. This, in effect, is what would be done under current value accounting, when cost of goods sold and depreciation and obsolescence are charged at current cost, while changes in the current value of inventory and plant and equipment are excluded from the calculation of net income by relegation to a separate statement.

Is there any merit to this view?

It is true that businessmen are concerned about maintaining "their share of the market," and this concern may foster the notion that net income in some truly relevant sense is income that is left over after providing for the maintenance of physical capital, or even the notion that income or income available for dividends is what is left over after providing for the maintenance of the firm's share of the market, which may mean after expanding capacity. I suspect that the insistence on physical capital as the capital that is to be maintained originates in the confusion generated in an inflationary era by conventional financial statements that are based on historical costs measured in dollar units. The provision for replacing goods sold and plant and equipment used up that is recorded in the conventional statements is obviously insufficient for the purpose by any reasonable definition of capital maintenance. The book values reported for inventories and plant and equipment will rise more rapidly than the physical or real capital they represent, and may rise even when the physical or real capital is deteriorating. What is needed is an adjustment of the financial statements to eliminate the distorting effects of a rising general price level—in a word, purchasing power accounting.

To adjust the statements also for changes in relative prices would eliminate market signals important to businessmen for the efficient management of their affairs. For their primary interest, we must remember, is to maintain or increase their firm's capacity to "make money" in the most remunerative way. It is not merely, or necessarily, to make money in the accustomed way. Their concern with physical capital maintenance is simply a concern with one of several means of making money. Like any means, it will be discarded when it is no longer as attractive a source as other means available to them.

This must be so in a world of change in which new products and new materials displace old, in which factor prices change, in which new markets are opened up and old markets disappear. It is a world shaped by innovation and adaptation to innovation, as Schumpeter taught us long ago. The business that counts its profit after providing for the maintenance of its physical capital, and fails to innovate or adjust to the innovations of more enterprising businessmen, eventually goes under.

Except for the peculiarities attached to LIFO, accounting under GAAP is properly focussed on this objective of making money, and is devoted to measuring the degree to which this objective has been attained. General purchasing power accounting aims to measure the same objective expressed in terms that allow—as they should—for inflation.

The LIFO exception under GAAP to historical cost accounting is a consequence of the requirement, under the tax code, to use LIFO in the financial statements when LIFO is used in the tax return.[9]

In an inflationary period, LIFO has the effect of indefinitely postponing some of the tax on business income as it would be were income measured under GAAP without the benefit of LIFO. It therefore provides a way of adjusting the income tax return for inflation. However, the adjustment it permits is seriously incomplete because it applies only to inventories. Further, should the physical quantity of inventories decline, some or all of the postponed taxes would become due. The fact that under LIFO changes in the relative prices of inventories are excluded from income might be considered as only a minor defect in the way it deals with inflation.

8. The Monetary Items in Purchasing Power Accounting

Current value accounting raises controversial questions regarding the disposition, between net earnings and credits directly to capital, of gains from holding assets and owing liabilities; and when these holding gains are counted as part of earnings, regarding their inclusion in operating income or in nonoperating income. But purchasing power accounting is not entirely free of this problem. Holding gains on monetary items come into question. In the FASB's model, and the AICPA's variant, these gains are treated as part of net earnings; but they could be treated otherwise.

[9]In this respect, the requirement differs from the regulation governing depreciation and obsolescence. Accelerated depreciation may be used for tax purposes, but need not be used for the financial statements. The difference is set forth in a note to the statements.

The issue requires our attention, which we limit to the monetary items in purchasing power accounting.

Under GAAP, liquidation by a company of its own long-term debt, by purchase in the market at less than par value, would be considered as yielding a realized nonoperating gain, to be included in net income. Unrealized gains of this sort would be ignored. Under purchasing power accounting, however—adhering to GAAP in other respects—such an unrealized gain (measured by the change in the debt's purchasing power caused by a rise in the general price level) is not ignored. It is included in net income, under the category of nonoperating gains. Revising GAAP in what appears to be just one respect—a shift from dollar units to general purchasing power units—also results in counting as income what under GAAP would be viewed as unrealized gains and excluded from income. As I mentioned earlier, this implication has raised a stumbling block to the acceptance of purchasing power accounting. What can be said about it?

Consider, first, the situation in an era in which the general price level has been rising for some considerable time, is continuing to rise at a more or less constant rate, and is generally expected to rise in the future—in a word, an era of inflation. Both borrowers and lenders will take into account the prospective decline in the purchasing power of the principal, as well as of later interest payments. Debt floated in these circumstances will bear an interest rate that includes an allowance for the expected rate of inflation. From the point of view of general purchasing power accounting, the interest payment may be seen as a gross payment or receipt, against which is to be credited or charged a revenue or cost reflecting the depreciation in the purchasing power of the obligation. In the borrower's income statement, the net interest payment in purchasing power units would be the gross amount less the gain. As in the treatment of depreciation and obsolescence charges, the gain could quite sensibly be viewed as a realized operating-income item. With appropriate changes, the treatment in the lender's income accounting would be the same.

Sharply in contrast is the situation in which the general price level is more or less stable, and inflation is not seen as a possibility serious enough to be reckoned with. Interest rates on loans would be set at rates that include no inflationary factor. Should inflation erupt later and persist, interest rates will rise and market values of debt incurred earlier and still outstanding will decline. Because this decline would not have been anticipated in setting the original terms, it could with good reason be viewed as a capital or extraordinary gain rather than an operating revenue. And there is also justification, though that is not so clear, to consider the gain as realized, even though liquidation of the debt by purchase in the market has not taken place.

What I have posed are obviously extreme, essentially theoretical cases, in order to point up the issue. As usual, the actual situation is not as clear. Even before 1965, from which year the current phase of inflation is dated, memories of the post-World War II and Korean War rises in the price level had not completely faded away; the average rate of inflation had fallen to low but not to negative levels; the threat of inflation was considered by some lenders to be worth worrying about, and "equity kickers" were becoming fashionable. Interest

rates may have contained only a modest inflationary factor, but whatever it was, it cannot be assumed to have been entirely negligible.

As for the situation after 1965, while the price level kept on rising, it did not do so at a steady pace—in substantial part because of "stop-go" efforts by government to dampen inflation. And interest rates on new loans moved up and fluctuated in resonance with the price level, responding also, of course, to the cyclical and secular forces that determine the real rate of interest.

It is not easy to determine the inflationary factor in interest rates in this situation, as economists making the attempt have come to realize. Yet we can be sure that the inflation factor in interest rates has been much greater in recent years than in the early 1960s; and that it is recognized as greater by more people. More the reason, therefore, to think of treating declines in the purchasing power of monetary items as elements of operating income rather than of nonoperating income, and certainly not to think of excluding the declines as unrealized. More than before, in other words, holding gains may be viewed as the result of "normal" business events that occur in an era of inflation, with which businessmen must deal as best they can, just as they have to deal with changes in the prices of the goods and services they buy and sell.[10]

But this is not the view that everybody holds, and the differences of opinion remain to be thrashed out. The differences are especially strong on the question of realization when liquidation of debt by purchase has not taken place. Under purchasing power accounting, realization is presumed simply as a consequence of the rise in the general price level.

How gains or losses resulting from changes in the purchasing power of the monetary items are treated makes a material difference. As I mentioned earlier, there was a large increase in the proportion of debt to equity financing during the post-war period; and in the aggregate, nonfinancial corporations are net debtors today. As a consequence, gains on net monetary items may offset a good part of, or even overpower, the rise in the replacement costs of nonmonetary items in years when inflation is rapid. However, even for 1973 and 1974—years of double-digit inflation—most companies covered in the FASB Research Report sample had net income in purchasing power units that fell short of GAAP net income.

Interfirm variation in the effect of holding gains on net earnings needs to be stressed because a major purpose of inflation accounting is to improve interfirm comparisons of earnings. Under GAAP these comparisons can be very misleading because of differences in balance-sheet structure. For 1972, not as inflationary a year as 1973 and 1974, the percentage decrease in net income expressed in purchasing power units, from GAAP net income in "mixed

[10]To recall Pigou's example, it is as if a country in which earthquakes are exceedingly rare, is transformed into a country in which they come as do changes in the weather. The damage done by earthquakes may then no longer be treated as capital losses, but must rather be considered as normal costs of doing business, to be provided for by insurance or otherwise, and taken into account in calculating operating income.

dollars," ranged from +61 percent to −36 percent in a sample of 58 firms.[11] Utilities and other firms making heavy use of funded debt show purchasing power income well above mixed-dollar income.

9. Concluding Remarks

Proposals to modify social arrangements in order to cope better with the new situations that inevitably arise in a dynamic world always encounter resistance. There will be those who oppose any change, for one reason or another; and those who agree that something must be done, but will differ on what to do, and how and when to do it. The case before us provides abundant illustration.

Surely persistent inflation is a new situation. Surely, also, it is important enough to require modification of the units in which economic calculations are made and reported. The general price level doubled in the United States during the past 15 years, and the outlook for soon attaining a reasonably stable price level is dim.

In a number of areas of economic life the problem of getting some agreement on a better unit of measurement is being overcome and the arrangements are being modified. Mention need be made only of the escalator clauses introduced in public and private pension systems and wage and other contracts on a widening scale.

Accounting for business income under inflation, however, is still only in the discussion and experiment stage. The exception—if it is an exception—concerns the limited and otherwise questionable requirements imposed by the SEC last year on the financial reports of large listed corporations. We are confronted, in official and unofficial sources, with a considerable variety of measures of business profits, or of the costs and value changes that go into the calculation of profits, adjusted in different ways for inflation. The adjusted estimates are radically different from one another, as well as from the unadjusted measures that appear in conventional financial statements or tax returns.

A glance at the current month's issue of the Department of Commerce's *Business Conditions Digest*, for example, reveals four widely different aggregates of business profits, all provided by the Bureau of Economic Analysis.[12] And

[11]The frequency distribution of firms by percentage decrease (increase) in net income from "mixed-dollar results" is worth presenting for 1972:

Percentage decrease	50 and over	40–49	30–39	20–29	10–19	0–9	(10)–(1)	(20)–(11)	Under (30)
Number of companies	2	3	6	10	21	7	2	3	2

Source: FASB, Research Report, Exhibit 2. Numbers within parentheses are negative.

[12]Profits after taxes, reported in the first quarter of 1977, relative to the previous peak in 1966, were as follows: according to the tax returns, up about 100 percent; the same in "1972 dollars," up about 10 percent; as reported on tax returns but with the BEA's inventory value and capital consumption adjustments (approximately equivalent to a shift from historical to replacement cost), up about 25 percent; the last, in 1972 dollars, down 30 percent. (The BEA's conversion to 1972 dollars is not quite an adjustment for change in the *general* purchasing power of the dollar, but it is not far from it.)

there are still other and different estimates of these aggregates, prepared occasionally by nongovernmental economists, that allow (as the BEA does not) for the reduction in the purchasing power of the monetary items that takes place as the general price level rises and also for holding gains on nonmonetary assets.[13] As for individual companies, the FASB Research Report mentioned earlier reveals wide variations in the degree to which their estimated earnings are altered by a conversion to purchasing power units. Application of inflation accounting procedures that involve a shift to current values as well as subsequent deflation shows a similar wide diversity of results.

Whatever doubts one may have about the choice of this or that concept and procedure, it is impossible to deny that the accounting problem raised by inflation is a serious matter. In some quarters, however, it is argued that it is best to let things alone, to stick with the "tested procedures that have served us so well in the past," rather than turn to untested concepts and measures that can serve only to confuse. No less strange is the argument that readers can make their own adjustments, in the financial statements that cross their desks, readily and cheaply enough to serve their purposes, and therefore nothing more is needed. It is difficult to treat this contention with any respect while loud complaints are being heard about the difficulties of preparing financial statements adjusted simply by a shift to general purchasing power units even when there is full access to the detailed books of account. Something more *is* needed.

No doubt GAAP has many features that require reconsideration. The validity of the dollar as the unit of measurement is not the only principle in question. But it is the question that is most urgent, the question that should be settled first.

The simplest and quickest way to deal with it is along the lines suggested by the FASB in its exposure draft two and a half years ago. Improvements might be made, and subsequent discussion has indicated some that deserve consideration. The use of a fixed base, such as 1972, instead of a shifting base rolled over from one year to another, would help people to think in purchasing power units more easily; and the term, "dollars of 1972 purchasing power" could then be substituted for the vaguer term, "purchasing power units." The line drawn between monetary and nonmonetary items might be shifted a bit. And the full detail suggested by the FASB might be replaced by a more concise presentation. It should be sufficient, however, to distinguish the several sources of change in income and stockholder's equity, measured in constant dollars, and to make possible a reconciliation of these with the corresponding changes in the GAAP statements. The purchasing power statements should be supplementary to the GAAP statements, at least at this stage. And they should be required, not left to the discretion of the management of each company.

Given these supplementary statements, all concerned groups—not only controllers, auditors and users but also the various governmental agencies involved, as well as the Congress, and the media—could begin to acquire

[13]Such estimates have been made by Shoven and Bulow, and by Kopcke (see the bibliographical note). These estimates would raise the level of 1977 adjusted profits, but apparently not enough to bring current profits in the aggregate (measured in general purchasing power units) up to their 1966 level.

adequate understanding of the nature of the accounting problem caused by inflation, and of what is required to deal with it. It would be a mistake even if it were possible, to supplant the present statements with a set based on purchasing power units (or a combination of current values and purchasing power units) before this educational process had run its long course. In any case, the present GAAP statements must continue to be available because many institutional and contractual arrangements—in bond indentures, tax returns, and public utility reports, for example—are geared to them, and while these will eventually change, they will change only slowly.

Later, further and more leisurely steps could be taken to pursue the questions about current value accounting and about other components of GAAP. These are not as urgent. Current value accounting is not a substitute for purchasing power accounting, and discussion of current value accounting tends to spill over into a discussion of the entire conceptual framework of financial accounting and reporting, concerning which there appears—to an economist, at least—to be some considerable confusion that will not be easy to clear up.[14]

To conclude: While I have argued that the solution to the problem of inflation accounting should be the one proposed by the FASB in its exposure draft, with some modifications, I am not very hopeful that it—or any other solution—will be accepted soon, if it is accepted at all. In its comments on "the next step," mentioned earlier, the FASB states that with regard to the question of measurement, "the Board cannot foresee the next course of action that it may take . . . Proposals for change in the attribute presently measured and presented may require more specific and detailed consideration than the Discussion Memorandum provides and might well require experimentation before a pronouncement is developed." So also the AICPA's Task Force, which, when describing the objective of its experiment, states that it considers "any present action toward a resolution of such fundamental issues as very preliminary . . . helpful [only] in pointing the way toward the next step. That step may well be in the form of further experimentation . . ."

To return to the FASB, its hesitation to move ahead decisively is apparent also in its "tentative conclusion" that for transitional purposes its pronouncements on concepts should initially not be statements of policy binding on AICPA members, according to which noncompliance by an audit client must result in a qualification of the auditor's report. A separate, nonbinding class of pronouncements by the FASB would "provide time to assess the impact of those concepts on existing standards and practices and the related transitional problems pending a definitive conclusion. Those policies would serve not only to

[14]An example is the distinction, of which much is made in the FASB's discussion memorandum, between the asset/liability approach to the measurement of earnings and the matching of revenues and expenses approach. So far as I can see, the two approaches differ only because of differences in the treatment of value changes and in the definitions of revenues and expenses. These differences have nothing to do with the approach. Given consistent positions on the treatment of value changes and the definitions mentioned, they would—should—yield identical results. More specifically, as I tried to indicate earlier, depreciation and obsolescence expense is—in principle at least—identical with the decline in the current value to the business of the assets subject to depreciation and obsolescence. Estimating the one implies estimating the other. The estimates may differ, but not because of a basic difference in concept, point of view, or approach.

guide the Board itself . . . but also to guide financial statement preparers, auditors, and users in understanding and applying those standards and in resolving accounting questions for which no standards have been promulgated." The road ahead may stretch long into the future.

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