Inflation and Financial Disclosures

Fallacy in Numberland

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In today's world, there is general agreement that one of the foremost economic problems facing society is that of inflation. Its effects are pervasive, and the areas of our primary responsibilities are certainly not exempt. Inflation affects the capital markets by depressing both equity prices, because of increased uncertainties and squeezed corporate profits, and debt prices due to higher interest rates demanded by investors. In addition, it tends to reduce the real supply of capital by encouraging consumption as compared to investment while at the same time making investment in financial assets less attractive.

While even the most ardent critic of accounting would not believe that deficient financial reporting was a principal culprit in creating inflation, it does seem plausible to suggest that the failure of accounting have perhaps exacerbated the problems of corporate managers, investors and government policy makers in dealing with an inflationary world. This stems in large part from our tendency to derive our financial data base for economic decision-making purposes solely from historical cost financial information statements. Although it appears that inflation is abating, the recent experience with high levels of inflation raises considerable question about the ability of historical cost financial statements standing alone to portray adequately inflationary impacts on individual companies. Further, even the lower inflation rates which are expected will be of such a level that expeditious consideration of various means of dealing with the problem clearly are in order. In short, it appears that a large part of our collective decision making designed to combat inflation is based on a questionable data base. As such, existing accounting may have contributed indirectly to some of the unfortunate effects of inflation even if it cannot be assigned blame for causing inflation.

Our first formal efforts in dealing with this problem area occurred early in 1974 with the issuance of Accounting Series Release No. 151 addressing the subject of "inventory profits." The release noted the reduced utility of historical financials in an inflationary environment and cited the need to consider a fundamental change in the accounting measurement model as part of the inflation accounting discussion. At that time, we noted that this was a long-term project, that it was premature for the Commission to suggest what form such a major change might take, and that the Financial Accounting Standards Board might examine the whole issue of inflation accounting. At the same time, the release cited the desirability of giving information currently which would assist in appraising inflation impacts on current operating results and suggested a replacement cost approach as a basis for measuring such impacts on the cost of sales amount.

Although the Commission felt that computation and disclosure of such information would be valuable, it made disclosure voluntary in recognition of the difficulties associated with the computation of replacement cost amounts. These difficulties stem primarily from the fact that replacement costs are not developed or recorded in most existing accounting systems. Moreover, the determination of such costs could introduce an added element of subjectivity where inventories must be replaced by equivalent, but not identical, items. The release also recognized the practical need for computational methods of bases of valuation other than strictly applied replacement cost methods. This explicit flexibility was intended to encourage experimentation with and development of various approaches in measuring the impact of inflation. Although these are not insignificant difficulties, we believed implementation problems could be resolved relatively quickly and that costs would be increased but reasonable given the value of the data to management, investors and others. For even though our primary interest is in providing information to investors, it seemed clear to us that management should be vitally interested in an approach that would indicate both the extent of inflationary impacts for the period and the extent to which prices would have to be raised to maintain profit margins.

Despite the apparent benefits and despite our interest in having registrants attempt to disclose “inventory profits” in some manner, I am sorry to say that we have seen virtually no efforts to provide this information or any other information designed to reflect inflationary impacts on operating results.

Because of this less than enthusiastic response--and because of our continued concern--the Commission recently issued a proposal calling for limited replacement cost data to be provided as supplementary footnote information. Specifically, we have asked for four pieces of information, two oriented toward the income statement and two toward the balance sheet. These are, first, cost of sales and depreciation computed on replacement cost basis and, secondly, the current replacement cost at the end of the year of productive capacity and inventories. Although this is a piecemeal approach, it is our belief that in most instances inflation associated with inventories and the cost of replacing productive capacity constitutes the most significant and immediate source of inflationary impacts on the current operations of individual reporting entities. We believe that this information will significantly assist investors in assessing the current economics of a business enterprise and will be of great assistance in making judgments about the future. That is, we believe that it will enable the investor to appraise better the firm's ability to cope with inflation and, concomitantly, the quality of its earnings.

While we have not suggested the historical financial statements are without value, we do believe that in a time of inflation and dramatic economic change they may lag reality sufficiently to be unreasonably biased if they are used uncritically. We do not have to look far to find examples of historical cost financial statements that do not reflect the all too real impact of rapidly increasing prices.

We have noted around the world a move in the direction of financial reporting based on replacement cost. In some countries some proposals have gone far beyond ours. I might add that this does give us some comfort since it indicates that others grappling with similar or even more aggravated problems of inflation have moved towards a similar possible solution. In Australia, for example, there has been a proposal that the basic financial statements be changed to use replacement cost information. In the United Kingdom, the recent report of the Sandilands committee made a similar recommendation. It may be that ultimately we should consider such a fundamental change. But the Commission believes that such a change should come from a careful study of all the issues such as the conceptual framework project now being undertaken by the Financial Accounting Standards Board.

In making our proposals we also gave consideration to the possibility of general price level adjusted financial statements as the only form of supplemental information. We concluded that such data would not be a sufficient answer even though we did not reach a conclusion that such information was without value. We believe that in an inflationary environment relative price changes sustained by an enterprise are very significant and that the application of a single general index representing a composite of all price changes in the economy cannot effectively communicate to investors--or for that matter to managers--how inflation is impacting on a particular enterprise. Because the general price level approach is based upon units of general constant purchasing power, it does not indicate the impact of relative price changes on enterprises.

We certainly recognize that our proposals are controversial and in making them we have provided for an extended comment period ending on January 31, 1976, so that all interested parties will have an opportunity to consider them with care in the light of their own situation and to supply us with their comments. We are not committed to the specific words of our proposal and recognize that it will impose additional costs upon registrants.

At the outset I would like to point out that we have spent a great deal of time attempting to determine how great the costs might be. There is no question that there will be costs associated with the data but it probably will surprise you that our inquiries to date indicate that they will not be as high as you might think. One big eight accounting firm estimates that it will be around three percent of the accounting department cost in the first couple of years. We have asked in the release that companies experiment with replacement cost and develop data on associated costs as well as techniques designed to keep the costs in line. It is clear that the first year will be the toughest--new data will have to be assembled, a wide variety of previously unneeded judgments will have to be made, and inevitably mistakes will be made. However, we believe that the exercise will become much easier after the first year. Moreover, we believe that experience will result in simplifying approaches for grouping various assets, deriving indices and making other necessary estimates. We also believe that replacement cost will not be significantly more costly than general price level data. On the other hand, we believe that it is much more relevant.

Let me try to be more specific about cost. During a recent meeting at the Commission we discussed with practicing accountants from a large firm some actual cases of recently implemented replacement cost systems. The first case discussed was a manufacturer with sales of about $60 million. This company had a very simple inventory costing system (having only one product and one principal raw material) but a very complex fixed asset situation. The cost of developing <u>complete</u> financial statements on a replacement cost basis was about $8,000. Although some additional overtime was incurred, no new personnel were needed. The company publicly released these data along with a related auditor's opinion.

Another case involved a manufacturing company with sales of about $180 million dollars. The company has a very complex multi-faceted manufacturing process without a standard cost system. This appears to be the most costly situation. In this case the company was able to produce summary data for about $30,000 in the first year. It was able to produce complete financial statement data which it felt was adequate for public disclosure--and which its auditors expressed willingness to attest to--for about $100,00. Moreover, it feels that such auditable data can be produced on an on-going basis for about $20,000. Most importantly, management purports to find the data extremely useful although they are still debating whether to make it public or not.

Mind you, this represents a small preliminary sampling. But it does give a strong indication that what we are proposing is within a feasible cost range.

In further consideration of the potential cost of such a system, we have asked for comments concerning whether replacement cost data initially should be required only of companies above certain size levels and whether such data should be labeled as unaudited. We have observed from early comments some agreement that requirements should only be imposed upon companies above a particular size. An analysis of these responses indicates that a mathematical expression of these views is possible. Commentators generally feel the rule should be applied to companies of a size of X plus $40 million, where X is the size of the commenting company. I should say in the interest of full and fair disclosure that we have not yet heard from any of the "Fortune 500" in this regard.

As is the case with most of our proposals, we expect that the most common criticism of the proposal will be that the cost-benefit relationship is out of line. We are concerned and we have asked registrants to be as specific as possible in commenting on the associated costs. However, because of our investigations to date, I must say that it is going to take a great deal to persuade me that the costs are disproportionate.

Moreover, it seems to me that there is a vital need for information of this sort, both to assist investors in making judgments about the current and future economic situation of the firm and also to assist managers in their decision-making processes.

I have noted that our principal concern is information for investors and I have indicated some of the benefits which we perceive for them from such data. More specifically, I believe that the data will be useful in indicating such things as whether the company is maintaining the value of its physical plant and whether current dividend distributions are impairing the present capital base and the future production and income generating potential of the company. Also, as the approach becomes defined I believe it will improve the ability of investors to compare the financial position and results of different companies.

On the other hand, I have also noted that the data are not developed solely for investor purposes. We have seen a number of examples of companies that have established replacement cost systems for their own internal purposes and found them extremely useful. While some companies have presented such data in external reports, the majority still use it solely for internal decision making. Although we cannot believe that managements are totally unaware of current costs, we do think that many do not have a system which brings such data to their attention on a regular basis as part of their system of regular control over operations. It seems reasonable to think that such data may be valuable. The recently issued Sandilands report in the United Kingdom speaks to this point as follows:

> "It is clear that in monitoring the progress of the company of the company and establishing pricing policy management needs to take account of the changing prices of the fixed and current assets which the company needs to purchase in order to carry on its business. Return on capital employed is widely used as a measure of the performance of a company as a whole and where appropriate by its separate divisions or 'profit centres.' For this purpose management must have access to reasonable estimates of the 'value to the business' of a company's assets. Without this information any assessment of the success of the company in utilizing the resources available to it will be distorted. Management also needs to know the value of assets on alternative bases so that the potential gains (if any) from selling the assets instead of employing them within the business can be calculated. . . .
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> "Management will also be interested in the division of the total gains made by the company between holding gains, operating gains and extraordinary gains. This will enable management to assess the extent to which gains are due to luck or sill in the timing of purchases (holding gains), to the productive efforts of the company (operating gains) or to exceptional transactions (extraordinary gains). This information is needed in order to judge the extent to which management has achieved its objectives. If the main purpose of the company is to generate operating gains, continuing operating losses (even during a period when large holding gains were made) would indicate that the present method of operation of the company could not be continued in the longer term after the present assets of the company are worn out."

Moreover, besides management there is considerable reason to believe that such measurements would be of great utility to tax policy planners attempting to assess inflationary impacts on the business sector. We have heard a great deal in recent years from the business and financial community about the inequities of our current tax structure and the fact that taxation based upon historically computed income may result in the erosion of our national capital base in an inflationary period. While I recognize the merit of this assertion, I think it also must be recognized that Congress cannot be expected to be responsive to the suggestion for a new basis of tax accounting as long as corporations are willing to report on one basis to their stockholders while at the same time urging another basis on the creators of the Internal Revenue Code. Management cannot have it both ways.

It seems essential, therefore, that business begin to develop systematic and regular data recording the impact of current costs that are part of their overall information system. Data which are developed only to make a tax case are suspect, particularly in an environment such as today's which I am afraid must be characterized as anti-business. I suspect that the ultimate recognition of replacement cost on a tax basis will not be easy to achieve. But without having it part of the regular corporate information system, I am convinced that it is impossible.

In the same vein, I believe that such data will be of great utility to national economic planners. The government collects most of its statistical data on the basis of cost data derived in accordance with the historical cost accounting model. While many of the agencies attempt to adjust the data for the impact of price changes, most of these adjustments are much cruder than we care to admit--and certainly more so than we would like. It is widely believed that national income measurements based on the cost to replace inventories and productive capacity would indicate that our national capital base is shrinking. This is obviously vital data to both business and government. Introducing even the proposed piecemeal approach would improve significantly our ability to measure this phenomena and, if necessary, to establish various policies designed to better stimulate investment.

I believe these benefits are far from insignificant and that they should be considered in appraising the value of moving in this direction. Using the replacement cost concept in a limited application has considerable appeal since it provides an opportunity to experiment with an approach promising substantial benefits without having to shoulder the burdens of cost and time associated with an attempt to completely adopt at the outset a new accounting measurement concept. Although we are mindful of the fact that even this limited approach will not be unburdensome, the immediate need for improved accounting recognition of inflationary impacts for all levels of financial statement users creates a sense of urgency and a strong desire to encourage the development of better measurement approaches as soon as possible. We are hopeful that our current proposal will be a step down that road.