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Price-level adjustments in financial statements

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IN

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CHAPTER I

INFLATION—AN ACCOUNTING PROBLEM

INTRODUCTION

The accounting profession has made some giant strides in becoming recognized as a needed profession. One of the reasons for this growth is the fact businessmen are relying more and more on the accounting profession to furnish them with a variety of financial information. In order for the accounting profession to furnish these management services and not lose its own independence, and also be able to attest to financial statements, it was necessary to set up some guidelines to follow. These guidelines were set up with the assumption the economy would be stable and ignored such outside influences as inflation. The accounting profession has been aware for some time that present principles of accounting do not handle the accounting problems of inflation properly. But, for some reason, the profession has made slow progress in overcoming this particular problem. Perhaps it is because the United States has not experienced the extreme inflation that many other countries have.

Knowing the problem was becoming more acute, both the American Institute of Certified Public Accountants, hereafter called the AICPA, and the American Accounting Association began studies to find a method to properly handle the problem of inflation in accounting. Both organizations stated that price-indexes should be used to place periodic financial statements on a common-dollar basis. However, as will be pointed out later, these two organizations could not agree as to what price index to use and how it should be applied. After researching the problem for a number of years, in June, 1969, the AICPA came out with Statement Number 3 of the Accounting Principles Board.[1] This statement gave strong recommendations as to the proper index to use and the procedure to follow in applying the index for supplemental statements. At the present time, this method appears to be accepted by a majority of the accounting profession.

This paper will show why the present principles of accounting do not adequately cope with inflation. The recommended method of the AICPA for making price-level adjustments will be applied to an actual set of financial statements from an existing business. Although one cannot draw general conclusions from the effect of price-level adjustments on one set of books, or determine its value from the reaction of one owner or one financier, an attempt will be made to see if an individual businessman does feel these statements can be of value in managing a business or running a financial institution. A comparison of the historical cost statements and the supplementary price-level adjusted statements will be made and conclusions drawn as to the validity of this approach.

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[1]AICPA, Financial Statements Restated for General Price-Level Changes, Statement No. 3 of the Accounting Principles Board (New York: AICPA, 1969).

INFLATION AND ITS EFFECT ON BUSINESS AND ACCOUNTING

One of the most serious problems facing our government, economists, and the accounting profession today is the problem of inflation. In fact, during 1969 to 1973 our country experienced an unusual situation where many of the economic tools designed to stop inflation have failed to accomplish what most economists and government officials had predicted. This problem has caused a great deal of concern in the business community and has increased the need for more meaningful financial statements.

What is inflation? Webster defines it in this manner: "An increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the general price level."[2] Tierney states: "The price (i.e., the value of exchange) of a unit of any good or service is an expression of <u>the bundle of things in general</u> which can be obtained in exchange for it. Similarly, the value of a unit of money is an expression of things in general for which it can be exchanged, and that value can vary for the same kinds of reasons."[3] From this explanation of the value of money, one can determine that if the price of a <u>bundle of things in general</u> is higher in one year than it was in the previous year, the economy has experienced inflation.

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[2] Webster, <u>Third New International Dictionary of the English Language</u>, Vol. I (Springfield, Mass.: G. & C. Merriam Co., 1961), p. 1159.

[3] Cecilia Tierney, "Price-level Adjustment—Problems in Perspective," <u>The Journal of Accountancy</u>, Vol. 116, No. 5 (November, 1963), p. 57.

What effect does inflation have on the business firm? Generally speaking, debtors and persons who own non-monetary property benefit from inflation, and those who have money claims against others are injured. Bonds, insurance policies, and annuities shrink in value. A company holding tangible property and owing fixed monetary obligations during a period of rising prices is generally in a more advantageous position than one holding monetary claims.[4]

How serious has inflation been in various countries of the world? The United States has experienced a great deal of inflation during recent years. Using 1967 as the base year, the Consumer Price Index indicates that on all consumer items the index has gone from 100.0 in 1967 to 130.7 in April of 1973.[5] This is an increase of more than 30 percent over slightly more than a five-year period. Economists believe an approximate 3 percent increase per year in the general price level creates a healthy economy. However, as can be seen from the above figures, there have been years in which the United States has experienced an increase much greater than 3 percent. In fact, the increase from January through April of 1973, a four-month period, the Consumer Price Index rose 3 percent, or a rate of approximately 9 percent a year.

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[4]Edward B. Wilcox, "Fluctuating Price Levels in Relation to Accounts," Handbook of Modern Accounting Theory by Morton Backer (New York: Prentice-Hall, Inc., 1955), pp. 253-254.

[5]U.S., Department of Commerce, Office of Business Economics, Survey of Current Business, Vol. 53, No. 5 (May, 1973).

Inflation in Europe has probably been recognized as a problem longer than in any other part of the world. Perhaps, this was brought about by the fact Europe became industrialized before other parts of the world and therefore suffered more economic "ups and downs" throughout the years. The wars of Europe and the great amount of importing and exporting carried on by the countries of Europe have all contributed to the problem of the constantly changing value of money. Following World War II, most of the countries of Europe were faced with extreme inflation. This situation became so serious that some of them were forced to revalue their monetary unit—either in terms of gold or the American dollar. More recently, the United States was also forced to revalue the dollar. In addition to this, some of the governments set up guidelines for businesses to follow in revaluing their assets.

In recent years South American countries and Japan have experienced some of the most extreme inflation in the world. Prices in many South American countries have more than doubled in one year. Brazil is one of these countries which has suffered most from inflation. This is evidenced by the fact that according to their wholesale price index, excluding coffee, the value of the cruzeiro in 1962 was one-twelfth what it was ten years earlier in 1952.[6] In Brazil, monetary assets such as cash and receivables lose value so fast that the businessman attempts to borrow as much as he can in order to transfer the devaluation losses

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[6]Arthur Andersen & Co., "A Practical Approach to Accounting for Inflation in Brazil" (Sao Paulo, Brazil: Arthur Andersen & Co., June, 1963), p. 1.

on his receivables to his creditors.[7] Creditors, in turn, raise the interest rate to overcome this loss due to lending. The government then makes more money available to try to keep the interest rate down. This adds more fuel to the fire of inflation.

Why is inflation an accounting problem? As was mentioned earlier, in order for accountants to accomplish their goals, they have, through the years, set up basic principles to follow in trying to prepare the most useful financial statements. One of these principles is objectivity. "Changes in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms."[8] The accountants, those who adhere to this principle of accounting, use objective data, generally the cost figure, for valuation purposes. This has become the basis for historical cost statements.

Historical cost statements have been in use for many years and have withstood the test of time, primarily because they are based upon verifiable evidence. It requires no appraisal or determination of future earning power as is the case in some other methods of valuation. Littleton states:

> In working to produce objective, verifiable data, accountants have become particularly aware of certain duties that rest upon management. Management

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[7]Andersen, "A Practical Approach to Accounting," p. 6.

[8]Harry Simons and Wilbert E. Karrenbrock, Intermediate Accounting (4th ed.; Dallas, Texas: South-Western Publishing Co., 1964), p. 47.

> is duty bound to invest (buy) enterprise assets at the most advantageous available price. That is a fundamental part of the working of our system of free enterprise. The system stands to suffer in some degree, and management surely is handicapped, if responsible executives cannot judge in retrospect the outcome of their prior commitments. A classified record of transactions stated in terms of invested costs (prior commitments) would seem an essential element for this use. As a consequence, accounting has an obligation to record and report historical or invested cost, not as a convention or tradition, but as a service necessity.[9]

Gradually the accounting profession has shifted in emphasis from the appraisal method of determining income in which the balance sheet would be the primary statement, to the results of operations, as shown on the income statement. As the monetary concept of income developed, more and more emphasis was placed on the common unit of measure—the dollar. One of the conventions of accounting states that there is a stable monetary unit. "Accounting reports should be based on a stable measuring unit . . . . Money is the common denominator in terms of which the exchangibility of goods and services, including labor, natural resources, and capital are measured."[10] Historical cost statements are based on the assumption that the economy has a stable monetary unit. A stable monetary unit is also necessary if consistency in reporting is to be achieved. "The procedures used in accounting for a given entity

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[9] A. C. Littleton, "Significance of Invested Cost," Readings in Accounting Theory by Paul Garner (Boston: Houghton Mifflin Company, 1966), p. 63.

[10] Maurice Moonitz, "The Basic Postulates of Accounting," Accountint Research Study No. 1 (New York: AICPA, 1961), p. 22.

should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period."[11] Inflation definitely has an effect on the monetary unit. When inflation continues to exist, the value of the monetary unit continues to decrease. In this situation, the monetary unit cannot be considered stable.

Historical cost financial statements no longer present a true picture. The average financial statement today does not present the financial condition and the results of operation of a business in a consistent manner because of the varying inflation with which we are plagued. Many attempts have been made to overcome inflation in financial statements. In fact, during the 1920s, most authorities completely disregarded historical cost as pointed out by Littleton:

> It is obviously hard to cling to original costs when most counsel is against it. This was particularly the case from about 1924 on. "Permanently higher level of prices," said economists; "assets are to be judged by earning power, not cost," said investment bankers; "replacement costs can be used in the rate base," said the utility commissions; "the dividend base shall be the excess of aggregate assets over debt and stated capital," said the legislatures; "short of proven fraud, directors shall have full legal authority to value assets as they see fit," said the courts. Then in 1931-1933 an epidemic of asset write-downs followed the prior wave of write-ups and unsettled original costs still further.[12]

As history has proven, the accounting profession returned to the use of historical cost and has not deviated much from it since. However,

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[11] Moonitz, "The Baisc Postulates of Accounting," p. 50.

[12] A. C. Littleton, "Value or Cost," The Accounting Review, Vol. X, No. 3 (September, 1935), pp. 271-272.

this does not mean that attempts should not be made as evidenced by Defliese:

> Since I am to speak as a practitioner, you may expect that what I shall say will be largely influenced by considerations of practicality. Despite this, I want you to realize that, personally, I believe the only way in which we ever achieve advancement in what may be termed practical accounting is by first developing and setting forth concepts toward which practice should strive.
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> As you are well aware, the practitioner must operate within his own frame of reference—this is, he can give recognition only to those economic changes which affect financial position and results of operations as determined by generally accepted accounting principles. Thus, he cannot stray far beyond the concepts that are presently understood and accepted by the business community or those that he believes could become acceptable. This does not mean that he cannot look forward to the day when the balance sheet and income statement will present financial position and results of operations in absolute or economic sense.[13]

IMPORTANCE OF THE STUDY

There are three groups of people who are primarily concerned with the financial statements of a business—management, investors and lenders, and government.

Management must satisfy many groups of people. They must answer to the directors, shareholders and the general investing community. They must furnish necessary information to industrial relations people

[13]Phillip L. Defliese, "A Practitioner's View of the Realization Concept," The Accounting Review, Vol. XL, No. 3 (July, 1965), p. 517.

in labor negotiations. They must try to minimize income tax obligations, and must do long-range planning in order to achieve the growth objectives set for the company.[14]

Investors and lenders, probably more than management, must rely on the accounting profession to see that the financial statements present fairly the financial position and results of operations for a company. For this reason, and others, it is the responsibility of accountants to improve financial statements so they do furnish the information needed by business.

There has already been a great deal of research done to overcome the stated problem. This will be shown in the next chapter. During recent years, there has been so much research done by so many people and so many different theories developed that prior to Statement No. 3 of the Accounting Principles Board of the AICPA the accounting profession could not seem to come to any kind of agreement. Ross describes this disagreement:

> First, we must start with the premise that our role is to provide service—more specifically to provide usable financial data to decisionmakers. In effect we are data processors. We should immediately forestall anyone who might object to this as somewhat menial work by insisting that this is a respectable, responsible, and demanding role. It is not a question of mechanically adding, subtracting and analyzing numbers. The designing, controlling and updating of systems is a challenging intellectual occupation, and every good statement prepared calls for fine judgment at every stage . . . . I think the second major reason for

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[14]Grant U. Meyers, "Accounting Problems Related to Price-level Changes," NAA Bulletin, Vol. XLVI, No. 3 (November, 1964), p. 3.

> our slow progress is that our discussions, while spirited and conscientious, proceed in a highly disorganized way. The fundamental reason for this is that we mix up <u>end</u> and <u>means</u> . . . . In the result, a group of experienced, intelligent, well-intentioned professional men spend a good deal of their valuable time to no purpose. The financial statements which come out are depressingly similar to those of the past.[15]

This form of evaluation in financial statements has become accepted by both the AICPA and the American Accounting Association. The use of this method is recommended by both of these organizations for the following reasons. In unadjusted statements, "monetary" items, such as cash, receivables, and payables are automatically stated in current dollars; however, unless these statements are adjusted there is no recognition of the purchasing power loss due to holding these assets. The "non-monetary" assets, such as inventories, plant, and equipment, if unadjusted, are shown at a conglomeration of dollars if purchased at various dates. In unadjusted statements, sales and expenses will be recorded at various values of the dollar. Depreciation is probably the most drastically affected expense item due to the fact it is based on assets which are generally purchased at many different points in time and showing many different values. Cost of goods sold will be affected in a similar fashion but to a lesser degree because the turnover period of inventories is shorter than that of plant and equipment.[16] When all of these distortions in an unadjusted financial

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[15]Howard I. Ross, "The Current Crisis in Financial Reporting," <u>The Journal of Accountancy</u>, Vol. 124, No. 2 (August, 1967), p. 67.

[16]AICPA, <u>Reporting the Financial Effects of Price-level Changes</u>, Accounting Research Study No. 6 (New York: AICPA, 1963), p. 24.

statement are put together, it can be seen that the gain or loss obtained from operations of a business can be very misleading. It may be misleading to investors, not only as to the nature of dividends received, but also as to the profitability of the enterprise. Also, as mentioned previously, with unadjusted statements it is useless to prepare comparative statements covering a period of years whenever there has been any significant change in the price level. Perhaps, the accounting profession has created a paradox when it attests to financial statements in which there are no adjustments made for inflation. The short form report states: ". . . on a basis consistent with that of the preceding year."

This report also includes the following passage: ". . . in accordance with generally accepted principles of accounting." These principles are valid only when they result in the best information that is objectively determinable with the means of measurement available at the time. If there is substantial evidence that measurement techniques are available which will produce more meaningful statements, as is the case in price-level adjustments, then the accounting profession could be justly criticized for attesting to unadjusted statements when they know they could disclose more meaningful information.

CHAPTER II

REVIEW OF PREVIOUS RESEARCH

RESEARCH DURING 1920 - 1930

There were certain events that took place in our economy which probably had a great deal of bearing upon the establishment of some of our principles or guidelines. During the 1920s and early 1930s, we went through a period in which there was a great deal of experimentation in financial statements. There were reasons for some of the problems which arose during this time. First, there were few guidelines to follow and second, there were no governing bodies, such as the Securities Exchange Commission, to police offenders.

There are times when more emphasis must be placed on valuation. This emphasis is necessary when the economy experiences extremes—"boom periods" and "depressions." During the 1920s there appeared to be a necessity for revaluing assets, because during this period the balance sheet was considered the major financial statement and current values were shown for liquidation purposes. As was stated earlier, there were few guidelines to follow and no governing bodies to establish controls. As a result, many different methods of revaluation were tried during this time.

One of these methods, as recommended by Rorem, was to find a suitable value for the assets by obtaining bids from companies which would be willing to purchase the plant. Also, a business could secure estimates from construction companies as to the present approximate cost of building a similar asset.[1]

Another method advocated by Scott was to find the difference between the market value and replacement cost. This amount would be added to the original cost and be depreciated over the remaining life of the asset.[2]

The majority of the methods in use during this period required some form of appraisal. These appraisals created problems within themselves. Appraisals are subjective and leave much room for manipulation. Much of the manipulation was done to deceive the investor and in many financial statements there were flagrant overvaluations. This was one of the causes of the stock market crash of 1929 and the subsequent formation of the Securities Exchange Commission in 1933.

RESEARCH BY INDIVIDUALS SINCE "THE GREAT DEPRESSION"

History has proven that people are inclined to forget. Even after the stock market crash of 1929, accountants continued to experiment with financial statements, using either replacement cost or market value, both of which require some form of appraisal.

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[1] C. Rufus Rorem, "Replacement Cost in Accounting Valuation," The Accounting Review, Vol. IV, No. 3 (September, 1929), p. 169.

[2] DR Scott, "Valuation for Depreciation and the Financing of Replacements," The Accounting Review, Vol. I, No. 4, Part I (December, 1929), pp. 224-225.

This method of valuation (replacement cost) is highly controversial. When prices move up or down radically, the discussion of the use of replacement cost recurs. However, it is seldom put into practice, because generally speaking, replacement cost is advocated by theorists and largely ignored by practicing accountants.[3]

There has been a great deal said about the use of replacement cost. Each advocate of the use of replacement cost seems to have his own theory as to how it should be determined. The methods for valuation of replacement cost range from simply using costs from suppliers' price lists to specific price indexes to complicated formulas.

Many of the newer methods of using replacement cost require the recognition of "holding gains and losses." This is evidenced by the 1964 Concepts and Standards Research Study Committee of the American Accounting Association in its report of "The Realization Concept." Horngren agrees with this concept in part:

> The reporting process should be broadened to encompass any upward value changes that can be supported by objective, verifiable evidence. Value changes such as increases in specific replacement prices for inventories should be recognized but labeled as unrealized if the assets in question are still being held . . . . The combination of a liberal recognition test and a strict realization test is the best practical means of obtaining what advocates of economic income measures deem as a desirable evaluation in financial reporting.[4]

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[3]Germain Boer, "Replacement Cost: A Historical Look," The Accounting Review, Vol. XLI, No. 1 (January, 1966), p. 97.

[4]Charles T. Horngren, "How Should We Interpret the Realization Concept," The Accounting Review, Vol. XL, No. 2 (April, 1965), pp. 331-332.

One should not confuse "holding gains and losses" which are based on value changes in assets with "general price-level gains and losses" which are recognized by the AICPA. "Holding gains and losses" may include general price-level changes, but also may include changes in value due to appreciation or depreciation caused by outside influences other than inflation.

Snavely does not agree with the policy of recognizing holding gains and losses as opportunity gains and losses. He feels a change in an asset's replacement cost can be caused by many things such as an increase in wages or a war in South Africa. Any cost increases due to causes of this type would not be a reliable measure of the increase in the asset's real value.[5]

Dickens and Blackburn are concerned about the fact that "holding gains and losses" can produce a wide fluctuation in reported income due to a relatively minor change in replacement cost. The example given states, in effect, if a business has a net investment of $100,000 in fixed assets with an average income of $10,000, a small change of 5% in replacement cost would cause a "holding gain or loss" equal to 50% of normal income. If these changes are not considered as objectively measurable elements of income, then the effect on reported income should be of concern because of its materiality.[6]

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[5] Howard J. Snavely, "Current Cost for Long-lived Assets: A Critical View," The Accounting Review, Vol. XLIV (April, 1969), p. 347.

[6] Robert L. Dickens and John O. Blackburn, "Holding Gains on Fixed Assets An Element of Business Income?" The Accounting Review, Vol. XXXIX (April, 1964), pp. 317-318.

Dickens and Blackburn point out another unusual situation which arises from the use of holding gains. Today, many writers are concerned with the fact that depreciation on the historical cost basis seriously overstates profits. In most cases, holding gains will more than offset current cost depreciation so that, in reality, the net cost under this situation is less than the historical-cost depreciation. This could cause even greater overstated profits. The extreme would occur when the difference between the holding gains and the restated depreciation would be greater than the historical-cost depreciation. This situation could create a paradox where a business would be using its stock of fixed assets at no net charge against income.[7] This creates an interesting sidelight, but would be highly unusual and contrary to generally accepted principles of accounting.

Another argument against the use of replacement cost is that substantially varying values could be assessed and defended as the replacement cost. Replacement cost and the resulting holding gains and losses could then be subject to management manipulation. Such statements would be of questionable value to investors in projecting future income or in evaluating the performance of management.

With regard to arguments against replacement cost, it may be concluded that it cannot be considered a useful figure to include in income, that a small percentage change in the value of a large stock of assets could have a distorting effect on a small operating income,

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[7]Dickens and Blackburn, "Holding Gains on Fixed Assets," pp. 319-320.

and that it is difficult to measure replacement cost objectively. Therefore, valuation by replacement cost and the reporting of income through "holding gains" are undesirable at the present time.[8]

Advocates of market value feel that management must know the current market price in order to make decisions concerning the future purchase and sale of assets. Market value, as mentioned earlier, has its shortcomings because of the need for judgment on the part of the appraiser. Goldschmidt and Smidt recognize other problems that can arise through the use of market value. They point out that there are three distinct complications that must be overcome if market prices are to be used to evaluate systematically all durable assets:

> These problems arise because (1) there may be a significant difference between the current acquisition cost of an asset and its liquidation value, (2) a direct market estimate of the current acquisition cost of an asset may be unavailable or irrelevant because of technological change that has occurred since the asset was acquired, and (3) even when a technological change has not occurred, the existing assets very often do not provide the same service as an equivalent new asset because of wear and tear.[9]

To justify their position of using market value, Goldschmidt and Smidt have set up a fairly complicated model to use in overcoming these complications mentioned above. The model basically is this: The ceiling for an asset's value would be its current acquisition cost (replacement

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[8] Dickens and Blackburn, "Holding Gains on Fixed Assets," p. 324.

[9] Y. Goldschmidt and S. Smidt, "Valuing the Firm's Durable Assets for Managerial Information," The Accounting Review, Vol. XLIV, No. 2 (April, 1969), p. 319.

cost). The floor would be its liquidation price. In setting up an asset's value, one would use either of these figures or some amount in between.[10]

They break their model down further. They state that a firm is constantly trying to analyze whether to buy another unit of an existing asset or to reduce the existing stock owned by the firm. If the accounting system is to furnish management with the information necessary to make these decisions, then both acquisition and liquidation values should be reported. The relevant value to be used would depend on management's plans. If management plans to expand the scale of operations, then replacement cost should be used as the basis for valuation. If it wishes to eliminate a product line or liquidate some assets, then liquidation value should be used.[11]

The above method of valuation might suffice for managerial needs but would probably not be of interest to outsiders in their analysis of financial statements.

RESEARCH PERFORMED BY PROFESSIONAL ORGANIZATIONS

The American Accounting Association led the way in setting up accounting and reporting standards for financial statements, when in June, 1936, the Executive Committee of the American Accounting Association issued a "Tentative Statement of Accounting Principles Affecting Corporate Reports." This was followed, in 1941, by a revision

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[10]Goldschmidt and Smidt, "Valuing the Firm's Durable Assets," p. 320.

[11]*Ibid.*, p. 321.

entitled "Accounting Principles Underlying Corporate Financial Statements" and, in 1948, by a second revision entitled "Accounting Concepts and Standards Underlying Corporate Financial Statements."

In 1949 a Committee on Concepts and Standards Underlying Corporate Financial Statements was appointed to consider special problems relevant to financial reporting. In 1951 the first organized attempt to cope with the valuation problem was made when the American Accounting Association issued a supplementary statement in regard to price-level changes and financial statements. In this Supplementary Statement No. 2, the Committee brought out the following points. The use of current or anticipated replacement cost of specific types of assets, as a means of measuring current-dollar costs, would represent a departure from historical cost and would, therefore, destroy to a considerable degree the objectivity of accounting. For purposes of determining periodic income, the cost of "consuming" existing capital should be used. This would rule out the use of any replacement costs. It would be acceptable, however, to restate historical costs in current dollars of equivalent purchasing power with the use of a general price index. The use of a general price index is independent of possible or probable future price changes since only past changes in the value of the dollar are reflected in the adjusted figures.[12]

[12] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements, Price-level Changes and Financial Statements Supplementary Statement No. 2 (Iowa City, Iowa: AAA, 1951), p. 26.

The Committee went on to report that adjustments by index number for changes in value of the monetary unit must not be viewed as a fact, but only as an indication of fact. They recommended the use of the Bureau of Labor Statistics Index of Wholesale Prices as an accurate and objective instrument for adjusting original dollar costs to reflect changes in the value of the dollar. It was pointed out that a better index could be developed when the need became apparent but that this index would serve reasonably well for experimental purposes.[13]

The Committee felt that these adjustments should be applied to all statement items. For example, if adjustments were made only to the income statement, then the impact of price-level change on the net balance of fixed-dollar items (assets fixed in dollar amount minus claims fixed in dollar amount) would not be disclosed. The gain or loss derived from these items, during periods of rising or declining prices, should be reported by analysis and adjustment of the balance sheet.[14]

To make proper disclosure, it was recommended that periodic reports to stockholders include supplementary statements which present the effects of the fluctuation in the value of the dollar upon net income and upon financial position. The supplementary statements should be consistent and should be adjusted by the same procedures so that the balance sheet and income statement have the same relative significance. They should be regarded as an extension of the primary statements. The

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[13] AAA, Accounting and Reporting Standards, Supplement No. 2, p. 27.

[14] Ibid.

statements should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the unadjusted data.[15]

It can be seen from the above recommendations that the Committee recognized the need of improvement of disclosure in financial statements. However, they were quite vague in their recommendations. For example, they were not clear as to the approach to use in applying the index to the various statement items. Also, they did not appear to be completely convinced that the Bureau of Labor Statistics Wholesale Price Index was the best to use. The Committee continued to maintain this same position and in 1954 in Supplementary Statement No. 8, "Standards of Disclosure for Published Financial Reports," they made the following statement. "The distorting effects of price-level change have been discussed at sufficient length in prior statements of this Committee to render further examination at this time unnecessary."[16] The Committee did emphasize the complexity of price-level effects and that any analysis of the effects of price-level changes should be done within the reporting company.[17]

In the 1957 revision of Accounting and Reporting Standards, the Committee on Accounting Concepts and Standards recognized that in

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[15] AAA, Accounting and Reporting Standards, Supplement No. 2, p. 27.

[16] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements, Standards of Disclosure for Published Financial Reports Supplementary Statement No. 8 (Iowa City, Iowa: AAA, 1954), p. 49.

[17] Ibid., p. 50.

addition to adjustments for changes in the general price level, adjustments may also be made for specific price changes. Thus, "supplementary data may be reported to reflect the effect of price changes in the specific assets held by the enterprise during the period, to show the effect upon the enterprise of movements in the general price level, or to achieve both purposes."[18] No positive recommendation was made, however, as to the preferred method of adjustment. This position taken by the American Accounting Association was a start in the right direction, but it needed a great deal of clarification.

The American Accounting Association maintained this position until the 1964 Concepts and Standards Research Study Committee made their report on "The Realization Concept." The main point of this committee's report is expressed in the following statement:

> A great variety of economic events determine the financial position (and change in position) of every business entity. Two crucial decisions that must be reached in accounting are (1) which of the economic events should be recorded in the accounts and (2) how the recorded events should be reported in the financial statements. On the first decision, the committee unanimously recommends that the effect of changes in value of all assets, other than goodwill, that can be supported by adequate evidence be recorded in the accounts. For the second question, a majority of the committee recommends that "unrealized" changes in the value of assets should not be included in the computation of reported net income, but should be shown on the income statement

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[18] American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements (1957 revision; Iowa City, Iowa: AAA, 1957), p. 9.

> below the net income line; on the position statement, the cumulative unrealized changes in value would be shown as a separate item in the retained earnings section.[19]

As can be seen from the brief explanation of "The Realization Concept," the American Accounting Association has made some drastic changes in its way of thinking. It is still advocating price-level adjustments by using price indexes to remove inflation from financial statements. However, they are now recommending the use of replacement cost and other methods to revalue assets which have appreciated in value. The use of price indexes to overcome inflation is becoming accepted more and more by the accounting profession, whereas "The Realization Concept" has become a controversial subject.

On November 4, 1960, the Accounting Principles Board of the American Institute of Certified Public Accountants discussed whether a consideration of the effects on accounting for price-level changes should be incorporated in the study of the basic postulates and broad principles of accounting or in a separate research project. After some study of the problem, it became clear that the price-level problem was too complex for adequate treatment in the postulates and principles studies. As a result the Board instructed the Director of Accounting Research to set up a research project to study the problem and to prepare a report in which recommendations would be made for the disclosure of the effect of price-level changes upon financial statements. Supplementary statements were to be given special attention as a means of disclosure.

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[19] AAA, 1964 Concepts and Standards Research Study Committee, "The Realization Concept," The Accounting Review, Vol. XL, No. 2 (April, 1965), p. 312.

The general feeling among the Board members was that in using price-level changes, the effects on all elements of the financial statements should be disclosed.

The study actually got under way in the fall of 1961. During the first meeting of the project advisory committee, the Director of Accounting Research pointed out that the problem of price-level changes had been discussed for many years, both here and abroad, and that techniques to deal with the problem in accounting had been developed and demonstrated without resolving the question as to what should be done at the reporting level. In view of the work done by others, the Director thought that the Institute's project could be simplified by concentrating on (1) a clarification of the meaning of "price-level adjustments" of the accounting data by the use of an index of the general price level, (2) a study of the indexes currently available, and (3) an exploration of the forms that disclosure of price-level changes has taken or could take.[20]

The result of this research is Accounting Research Study No. 6, "Reporting the Financial Effects of Price-level Changes," and more recently Statement No. 3 of the Accounting Principles Board, "Financial Statements Restated for General Price-level Changes." Before publishing Statement No. 3, the AICPA conducted a field test of 18 companies in the United States, using the recommended method of making price-level adjustments. The field test showed that it is difficult to make any

[20]AICPA, Reporting the Financial Effects of Price-level Changes, Research Study No. 6, p. 2.

generalizations as to how restatement will affect financial statements of companies in particular industries. Certain observations were made, however, as to what effect the restatement might have:

> First, capital-intensive companies tend to be affected more by restatement than others. Depreciation charges are more substantial, and restatement of these charges for the inflation since acquisition of the assets is a major factor in these companies. Second, companies with rapid turnover and consequently with relatively low inventory in relation to sales are less affected than companies with expensive slower moving inventory. Third, financing plays an important role. Debtors gain and creditors lose in an inflationary economy. Companies that must carry heavy receivables bear general price-level losses on them. Companies that finance their operations more heavily with debt gain more from inflation than those which rely more heavily on equity financing. General price-level gains on debt are offset, of course, by increasing interest rates as the rate of inflation rises. Borrowers in countries with severe inflation must pay high interest rates to compensate their creditors for losses the creditors suffer due to inflation. Only general price-level financial statements show the general price-level gains of the borrowers which tend to offset the high interest charges.[21]

Due to the fact that these studies will be used as a guide when applying price indexes to financial statements later in this paper, they will not be discussed at great length at the present time.

Generally, the AICPA agrees with the American Accounting Association as to how price-level changes should be handled. They both agree that disclosure should be made in the form of supplementary statements

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[21] Paul Rosenfield, "Accounting for Inflation—A Field Test," The Journal of Accountancy, Vol. 127, No. 6 (June, 1969), p. 49.

and that adjustment should be made to all items not just part of the accounts. The AICPA feels that, normally, a general price index should be used in making adjustments, whereas the American Accounting Association recommends the use of either a general price index or specific index for certain items or both. The AICPA has been much more direct, however, with regard to the procedure to be followed in applying the indexes.

CHAPTER III

FINANCIAL STATEMENTS RESTATED FOR GENERAL PRICE-LEVEL CHANGES

INTRODUCTION

The company used in the illuatration for restating financial statements is an existing entity which started business as a corporation in 1964, five years before restatement. At the request of the owner, the identity of the company has been disguised, using the fictitious name of the XYZ Company.

Statement No. 3 of the Accounting principles Board of the AICPA will be used as a guideline in making restatement of the financial statements. For additional information with regard to restatement refer to this bulletin.[1]

Before presenting the actual restatement of financial statements, there are two important points which should be emphasized with regard to historical cost financial statements and general price-level adjusted financial statements.

First, general price-level financial statements take into account changes in the general purchasing power of money. These changes

[1]AICPA, Financial Statements Restated for General Price-level Changes, Statement No. 3 of the Accounting Principles Board (New York: AICPA, 1969).

are not taken into account in the historical cost statements used in the United States today. All items in the financial statements are stated in terms of dollars of the period in which they originated.

The basic difference between general price-level and historical cost financial statements is the unit of measure used in the statements. Dollars which represent the same amount of general purchasing power are used in general price-level statements whereas dollars which represent diverse amounts of general purchasing power are used in historical cost statements.

The second point is that the use of general price-level statements does not deviate from the cost principle on which historical statements are based. The process of restating historical costs in terms of a specified amount of general purchasing power does not propose to introduce any factors other than general price-level changes. The amounts shown in general price-level financial statements are not intended to represent appraisal values, replacement cost, or any other measure of current value.

PROCEDURES TO PREPARE GENERAL PRICE-LEVEL FINANCIAL STATEMENTS

Information about the company:

1. XYZ Company started business as a corporation in 1964, five years before restatement.

2. Depreciation is computed on both the straight-line basis and the double-declining balance method. It is computed from the date of purchase.

3. Sales and expenses (other than depreciation, amortization of prepaid expenses, and deferred income realized) have taken place fairly evenly throughout the year.

4. Interest expense in included in the regular expenses.

5. The company has no inventory because it is a service-type organization.

6. In the original financial statements, agency commissions were shown as a cost of sales item. In order to follow proper accounting procedures, these expenses were transferred to other operating expenses.

The historical cost statements needed for 1968, the first year for which statements are to be restated, are balance sheets at the beginning and end of the year and the statements of income and retained earnings, and other changes in owners' equity for the year. For each subsequent year, only the balance sheet at the end of the year and the statements of income and retained earnings, and other changes in owners' equity for the year are needed. The historical cost balance sheet at the beginning of 1968 is restated to determine the restated amount of retained earnings at the beginning of the first year.

The GNP Implicit Price Deflator is used as the index of changes in the general price level. This index is available on both a quarterly and annual average basis. The annual average index is used for 1964, 1965, and 1966 because the results are not materially different from using quarterly indexes. For the years 1967, 1968, and 1969, both quarterly and annual average indexes are used. The index at the end of the year is approximated by using the average for the last quarter of the year.

Conversion factors determined and used in the restatement are computed from general price-level index numbers by dividing the index number for the current balance sheet date by each of the other index numbers. To illustrate, assume that 1964 and 1968 expenditures are to be restated to dollars of December, 1969, general purchasing power. The following GNP Deflators are applicable:

Average for 1964	108.9
Average for 1968	121.8
Fourth quarter 1969	128.1

To compute the conversion factors for restatement to dollars of general purchasing power current at December 31, 1969, divide the index number for the fourth quarter of 1969 by each of the other index numbers.

$$1964 - 128.1 \div 108.9 = 1.198$$

$$1968 - 128.1 \div 121.8 = 1.071$$

To restate a non-monetary item purchased in 1964, multiply its cost by 1.198:

Cost in 1964 dollars	$16,470
	X 1.198
Cost in dollars current at December 31, 1969	$19,731

The cost of $16,470 in 1964 dollars is equal to a cost of $19,731 in December 31, 1969, dollars. The cost is not changed; it is merely stated in a larger number of a smaller unit of measure.

GENERAL STEPS TO PREPARE GENERAL PRICE-LEVEL FINANCIAL STATEMENTS

1. Monetary and non-monetary assets and liabilities were identified as follows:

Monetary items:
- Cash
- Receivables
- Cash surrender value of life insurance
- Current liabilities
- Long-term debt

Non-monetary items:
- Prepaid expenses
- Plant, property, and equipment
- Accumulated depreciation
- Appraisal increase
- Deferred income
- Capital stock

2. Analyze all non-monetary items in the balance sheet of the current year (and the prior year for the first year of restatement) to determine when the component money amounts originated.

Schedule the data by years, using the average general price level for the year.

Retained earnings need not be analyzed. Retained earnings in the restated balance sheet at the beginning of the first year for which general price-level restatements are prepared can be computed as the balancing amount. Retained earnings in subsequent restated balance sheets is determined from the restated statements of income and retained earnings.

3. Analyze all revenue, expense, gain, and loss items in the income statement of the current year, and any changes in retained earnings during the year, to determine when the amounts originated that

ultimately resulted in the charges and credits in the statements of income and retained earnings.

4. Restate the non-monetary items. Multiply the component amounts of non-monetary items in the balance sheet of the current year (and the prior year for the first year of restatement) and in the statement of income and retained earnings for the current year by the conversion factors applicable to the components.

5. Restate the monetary items in the balance sheet at the beginning of the first year. Monetary items at the beginning of the first year must be restated from prior year's dollars to dollars of current general purchasing power by using the conversion factor applicable to the end of the prior year. Monetary items in the balance sheet, at the end of each year for which statements are restated, are stated in dollars of current general purchasing power and need no restatement.

6. Compute the general price-level gain or loss for the current year.

7. "Roll forward" the restated statements of the prior year to dollars of current general purchasing power. Financial statements of the prior year which were restated to dollars current at the end of the current year simply by multiplying each amount by the conversion factor applicable to the end of the prior year. This "rolling forward" serves two purposes: (1) it provides the amount of retained earnings at the end of the prior year in current dollars for the current year statement of retained earnings and (2) it provides the prior year statements in current dollars for use as comparative statements.

EXHIBITS AND WORKSHEETS ILLUSTRATING RESTATEMENT, 1968

1968 Restatement—XYZ Company

EXHIBITS AND WORKSHEETS ILLUSTRATING RESTATEMENT, 1969

1969 Restatement—XYZ Company

EXHIBIT A

XYZ COMPANY

COMPARATIVE BALANCE SHEETS

DECEMBER 31, 1969 and DECEMBER 31, 1968

	Dec. 31, 1969	Dec. 31, 1968
ASSETS		
Current assets:		
Cash	$ 11,961	$ —
Receivables—net	15,786	18,606
Prepaid expenses	788	1,281
Total current assets	$ 18,535	$ 19,887
Plant, property, and equipment	$ 91,163	$ 91,022
Less: Accumulated depreciation	(37,972)	(31,803)
	$ 53,191	$ 59,219
Appraisal increase	16,470	16,470
Cash surrender value of life insurance	1,738	3,650
Total assets	$ 89,934	$ 99,226
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities	$ 16,460	$ 29,172
Deferred income—payments received in adv.	1,301	1,719
Long-term debt	35,199	24,576
Stockholders' equity:		
Capital stock—common	45,110	55,110
Retained earnings (deficit)	(8,136)	(11,350)
Total stockholders' equity	$ 36,974	$ 43,759
	$ 89,934	$ 99,226

EXHIBIT B

XYZ COMPANY

COMPARATIVE STATEMENTS OF
INCOME AND RETAINED EARNINGS

YEARS ENDED DECEMBER 31, 1969 and DECEMBER 31, 1968

	Dec. 31, 1969	Dec. 31, 1968
Sales	$ 126,943	$ 121,697
Operating expenses:		
Depreciation	6,452	6,712
Other expenses	124,963	126,704
	$ 121,415	$ 133,416
Operating profit (loss)	$ (5,372)	$ (11,719)
Gain on sale of equipment	6,766	—
Income before taxes	$ 1,394	$ (11,719)
Montana corporation tax	220	10
Net income (loss)	$ 1,174	$ (11,729)
Retained earnings—beginning of year	(11,350)	(1,048)
	$ (10,176)	$ (12,777)
Federal tax refund		237
Increase in cash surrender value of life insurance	2,040	1,190
Retained earnings—end of year	$ (8,136)	$ (11,350)

NOTE: Information in regard to financial statements.

a. The general price-level statements are supplementary to the basic historical-dollar financial statements.

b. All amounts shown in general price-level statements are stated in terms of units of the same general purchasing power by use of an index of changes in the general purchasing power of the dollar.

c. The general price-level gain or loss in the general price-level statements indicates the effects of inflation on the company's net holdings of monetary assets and liabilities. The company gains or loses general purchasing power as a result of holding these assets and liabilities during a period of inflation.

d. In all other respects, the same generally accepted accounting principles used in the preparation of historical-dollar statements are used in the preparation of general price-level statements.

e. The amounts shown in the general price-level statements do not purport to represent appraised value, replacement cost, or any other measure of the current value of assets or the prices at which transactions would take place currently.

f. The general price-level statements of prior years presented for comparative purposes have been updated to current dollars. This restatement of prior years' general price-level statements is required to make them comparable with current information. It does not change the prior periods' statements in any way except to update the amounts to dollars of current general purchasing power.

EXHIBIT C
1968

XYZ COMPANY

GENERAL PRICE-LEVEL BALANCE SHEET

DECEMBER 31, 1968

	General Price-level Basis (Restated to 12/31/68)
ASSETS	
Current assets:	
Cash	$ —
Receivables—net	18,606
Prepaid expenses	1,335
Total current assets	$ 19,941
Plant, property, and equipment	$ 102,593
Less: Accumulated depreciation	(35,777)
	$ 66,816
Appraisal increase	$ 18,677
Cash surrender value of life insurance	$ 3,650
Total assets	$ 109,084
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities	$ 29,172
Deferred income—payments received in advance	1,769
Long-term debt	24,576
Stockholders' equity:	
Capital stock—common	62,495
Retained earnings (deficit)	(8,928)
Total stockholders' equity	$ 53,567
	$ 109,084

EXHIBIT D
1968

XYZ COMPANY

GENERAL PRICE-LEVEL STATEMENT
OF INCOME AND RETAINED EARNINGS

YEAR ENDED DECEMBER 31, 1968

	General Price-level Basis (Restated to 12/31/68)
Sales	$ 123,421
Operating expenses:	
Depreciation	7,473
Other expenses	128,531
	$ 136,004
Operating profit (loss)	$ (12,583)
General price-level gain	1,149
Income (loss) before taxes	$ (11,434)
Montana corporation tax	10
Net income (loss)	$ (11,444)
Retained earnings, December 31, 1967	1,067
	$ (10,377)
Federal tax refund	242
Increase in cash surrender value of life insurance	1,207
Retained earnings, December 31, 1968	$ (8,928)

EXHIBIT E
1969

XYZ COMPANY

COMPARATIVE GENERAL PRICE-LEVEL BALANCE SHEETS

DECEMBER 31, 1969 and DECEMBER 31, 1968

	General Price-level Basis (Restated to 12/31/69)	
	Dec. 31, 1969	Dec. 31, 1968
ASSETS		
Current assets:		
Cash	$ 1,961	$ —
Receivables—net	15,786	19,667
Prepaid expenses	836	1,411
Total current assets	$ 18,583	$ 21,078
Plant, property, and equipment	$ 108,536	$ 108,441
Less: Accumulated depreciation	(45,049)	(37,817)
	$ 63,487	$ 70,624
Appraisal increase	19,731	19,731
Cash surrender value of life insurance	1,738	3,858
Total assets	$ 103,539	$ 115,302
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities	$ 16,460	$ 30,835
Deferred income—payments received in adv.	1,368	1,870
Long-term debt	35,199	25,977
Stockholders' equity:		
Capital stock—common	54,042	66,057
Retained earnings (deficit)	(3,530)	(9,437)
Total stockholders' equity	$ 50,512	$ 56,620
	$ 103,539	$ 115,302

EXHIBIT F
1969

XYZ COMPANY

COMPARATIVE GENERAL PRICE-LEVEL STATEMENTS OF INCOME AND RETAINED EARNINGS

YEARS ENDED DECEMBER 31, 1969 and DECEMBER 31, 1968

	General Price-level Basis (Restated to 12/31/69)	
	Dec. 31, 1969	Dec. 31, 1968
Sales	$ 128,532	$ 130,456
Operating expenses:		
Depreciation	$ 7,571	$ 7,899
Other expenses	127,426	135,858
	$ 134,997	$ 143,757
Operating profit (loss)	$ (6,465)	$ (13,301)
Gain on sale of equipment	$ 6,935	$ —
General price-level gain	3,583	1,214
	$ 10,518	$ 1,214
Income (loss) before taxes	$ 4,053	$ (12,087)
Montana corporation tax	224	10
Net income (loss)	$ 3,829	$ (12,097)
Retained earnings—beginning of year	(9,437)	1,128
	$ (5,608)	$ (10,969)
Federal tax refund	—	256
Increase in cash surrender value of life insurance	2,078	1,276
Retained earnings—end of year	$ (3,530)	$ (9,437)

12/31/68
R-1

XYZ COMPANY

GENERAL PRICE-LEVEL RESTATEMENT—1968

GROSS NATIONAL PRODUCT IMPLICIT PRICE DEFLATORS AND CONVERSION FACTORS

Year	Quarter	GNP Deflators	Conversion factors, 1968 4th qtr.=1.000
Annual Average			
1964		108.9	1.134
1965		110.9	1.114
1966		113.9	1.084
1967		117.3	1.053
1968		121.8	1.014
Quarterly			
1967	1st	116.0	1.065
	2nd	116.6	1.059
	3rd	117.7	1.049
	4th	118.9	1.039
1968	1st	120.0	1.029
	2nd	121.2	1.019
	3rd	122.3	1.010
	4th	123.5	1.000

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
WORKING BALANCE SHEETS—12/31/67 and 12/31/68

	12/31/67			12/31/68		
	Historical	Conversion factor or source	Restated to 12/31/68	Historical	Conversion factor or source	Restated to 12/31/68
Assets:						
Cash	$ 681	(1) 1.039	$ 708	$ —		$ —
Receivables—net	16,930	(1) 1.039	17,590	18,606	(2)	18,606
Prepaid expenses	1,277	R-4	1,366	1,281	R-4	1,335
Total current assets	$ 18,888		$ 19,664	$ 19,887		$ 19,941
Plant, property, and equipment (at cost)	$ 91,171	R-5	$ 102,900	$ 91,022	R-5	$ 102,593
Less: Accumulated deprec.	(26,915)	R-6	(30,336)	(31,803)	R-6	(35,777)
Appraisal increase	16,470	(3) 1.134	18,677	16,470	1.134	18,677
Total	$ 80,726		$ 91,241	$ 75,689		$ 85,493
Cash surrender value of life insurance	$ 6,050	(1) 1.039	$ 6,286	$ 3,650	(2)	$ 3,650
Total assets	$ 105,664		$ 117,191	$ 99,226		$ 109,084
Liabilities:						
Current liabilities	$ 19,671	(1) 1.039	$ 20,438	$ 29,172	(2)	$ 29,172
Deferred income	205	R-7	228	1,719	R-7	1,769
Long-term debt	31,726	(1) 1.039	32,963	24,576	(2)	24,576
Total liabilities	$ 51,602		$ 53,629	$ 55,467		$ 55,517
Stockholders' equity:						
Capital stock	$ 55,110	(3) 1.134	$ 62,495	$ 55,110	1.134	$ 62,495
Retained earnings	(1,048)	(4)	1,067	(11,350)		(8,928)
	$ 54,062		$ 63,562	$ 43,759		$ 53,567
	$ 105,664		$ 117,191	$ 99,226		$ 109,084

(1) 12/31/67 monetary items before restatement are stated in 12/31/67 $s. The conversion factor for the end of 1967 is used to restate them to 12/31/68 $s. (2) 12/31/68 monetary items need no restatement because they are stated in 12/31/68 $s. (3) Business changed hands in middle of 1964, therefore, conversion factor for 1964 is used. (4) 12/31/67 retained earnings restated in amount which makes the balance sheet balance.

12/31/68
R-3

XYZ COMPANY

GENERAL PRICE-LEVEL RESTATEMENT—1968

WORKING STATEMENT OF INCOME AND RETAINED EARNINGS

	Historical	Conversion factor or source	Restated to 12/31/68 $s
Sales	$ 121,697	R-8	$ 123,421
Operating expenses:			
Depreciation	6,712	R-6	7,473
Other expenses	126,704	R-9	128,531
	$ 133,416		$ 136,004
Operating profit (loss)	$ (11,719)		$ (12,583)
General price-level gain	—		1,149
Income (loss) before taxes	$ (11,719)		$ (11,434)
Montana corporation tax	10	(1) 1.014	10
Net income (loss)	$ (11,729)		$ (11,444)
Retained earnings—12/31/67	(1,048)		1,067
	$ (12,777)		$ (10,377)
Federal tax refund	237	(2) 1.019	242
Increase in cash surrender value of life insurance	1,190	(1) 1.014	1,207
Retained earnings—12/31/68	$ (11,350)		$ (8,928)

(1) Assumed accrued ratably throughout the year.

(2) Received at end of 2nd quarter.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
ANALYSIS OF PREPAID EXPENSES

Year acq.	Factor to restate to 12/31/68 $s	Historical Balance 12/31/67	Historical Addit.	Historical Amort.	Historical Balance 12/31/68	Restated to 12/31/68 $s Balance 12/31/67	Restated Addit.	Restated Amort.	Restated Balance 12/31/68
1966	1.084	317		317		344		344	
1967	1.065	960		480	480	1,022		511	511
1968									
1st q.	1.029		1,236	435	801		1,272	448	824
		1,277	1,236	1,232	1,281	1,366	1,272	1,303	1,335

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
ANALYSIS OF PLANT, PROPERTY, AND EQUIPMENT

Year acq.	Factor to restate to 12/31/68 $s	Historical Balance 12/31/67	Historical Addit.	Historical Retir.	Historical Balance 12/31/68	Restated to 12/31/68 $s Balance 12/31/67	Restated Addit.	Restated Retir.	Restated Balance 12/31/68
1964	1.134	72,180			72,180	81,852			81,852
1965	1.114	15,391		1,825	13,566	17,146		2,032	15,114
1966	1.084	3,600			3,600	3,902			3,902
1968									
1st q.	1.029		1,676		1,676		1,725		1,725
		91,171	1,676	1,825	91,022	102,900	1,725	2,032	102,593

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
ANALYSIS OF ACCUMULATED DEPRECIATION

12/31/68
R-6

Year acq.	Factor to restate to 12/31/68 $s	Historical				Restated to 12/31/68 $s			
		Balance 12/31/67	Deprec.	Retir.	Balance 12/31/68	Balance 12/31/67	Deprec.	Retir.	Balance 12/31/68
1964	1.134	18,883	3,577		22,460	21,413	4,056		25,469
1965	1.114	7,214	1,838	1,824	7,228	8,036	2,048	2,032	8,052
1966	1.084	818	621		1,439	887	673		1,560
1968 1st q.	1.029		676		676		696		696
		26,915	6,712	1,824	31,803	30,336	7,473	2,032	35,777

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
ANALYSIS OF DEFERRED INCOME

12/31/68
R-7

Year acq.	Factor to restate to 12/31/68 $s	Historical				Restated to 12/31/68 $s			
		Balance 12/31/67	Addit.	Realiz.	Balance 12/31/68	Balance 12/31/67	Addit.	Realiz.	Balance 12/31/68
1965	1.114	205		205		228		228	
1968 1st q.	1.029		1,719		1,719		1,769		1,769
		205	1,719	205	1,719	228	1,769	228	1,769

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
ANALYSIS OF SALES

12/31/68
R-8

	Historical	Conversion factor or source	Restated to 12/31/68 $s
Sales:			
Current sales	121,492	(1) 1.014	123,193
Deferred sales realized	205	R-7	228
	121,697		123,421

(1) Spread fairly evenly throughout the year.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1968
ANALYSIS OF EXPENSES

12/31/68
R-9

	Historical	Conversion factor or source	Restated to 12/31/68 $s
Amortization of prepaid expenses	1,232	R-4	1,303
Other expenses	125,472	(1) 1.014	127,228
	126,704		128,531

(1) Spread fairly evenly throughout the year.

12/31/68
R-10

XYZ COMPANY

GENERAL PRICE-LEVEL RESTATEMENT—1968

GENERAL PRICE-LEVEL GAIN OR LOSS

	Source	12/31/67 Historical	12/31/67 Restated to 12/31/68 $s	12/31/68 Historical stated in 12/31/68 $s
Net monetary items:				
Cash	R-2	$ 681	$ 708	$ —
Receivables	R-2	16,930	17,590	18,606
Cash surrender value of life insurance	R-2	6,050	6,286	3,650
Current liabilities	R-2	(19,671)	(20,438)	(29,172)
		$ (27,736)	$ (28,817)	$ (31,492)

	Historical	Source	Restated to 12/31/68 $s
General price-level gain or loss			
Net monetary items—12/31/67	$ (27,736)	as above	$ (28,817)
Add:			
Current sales	121,492	R-8	123,193
Additions to deferred income	1,719	R-7	1,769
Federal tax refund	237	R-3	242
Increase in cash surrender value of life insurance	1,190	R-3	1,207
	$ 96,902		$ 97,594
Deduct:			
Expenses	$ 125,472	R-9	$ 127,228
Montana corporation tax	10	R-3	10
Purchase of equipment	1,676	R-5	1,725
Additions to prepaid expense	1,236	R-4	1,272
	$ 128,394		$ 130,235
Net monetary items—historical 12/31/68 (as above)	$ (31,492)		
Net monetary—restated 12/31/68 (if there was no gain)			$ (32,641)
Net monetary items—12/31/68			$ (31,492)
General price-level gain			$ 1,149

12/31/69
R-1

XYZ COMPANY

GENERAL PRICE-LEVEL RESTATEMENT—1969

GROSS NATIONAL PRODUCT IMPLICIT PRICE DEFLATORS AND CONVERSION FACTORS

Year	Quarter	GNP Deflators	Conversion factors, 1969 4th qtr.=1.000
Annual Average			
1964		108.9	1.198
1965		110.9	1.177
1966		113.9	1.146
1967		117.3	1.113
1968		121.8	1.071
1969		128.1	1.019
Quarterly			
1968	1st	120.0	1.088
	2nd	121.2	1.077
	3rd	122.3	1.067
	4th	123.5	1.057
1969	1st	125.7	1.038
	2nd	127.3	1.025
	3rd	129.1	1.011
	4th	130.5	1.000

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
WORKING BALANCE SHEETS—12/31/68 and 12/31/69

	12/31/68		12/31/69		
	Restated to 12/31/68 $s (1)	Restated to 12/31/69 $s (2)	Historical	Conversion factor or source	Restated to 12/31/69 $s
Assets:					
Cash	$ —	$ —	$ 1,961	(3)	$ 1,961
Receivables—net	18,606	19,667	15,786	(3)	15,786
Prepaid expenses	1,335	1,411	788	R-4	836
Total current assets	$ 19,941	$ 21,078	$ 18,535		$ 18,583
Plant, property, and equipment (at cost)	$ 102,593	$ 108,441	$ 91,163	R-5	$ 108,536
Less: Accum. depreciation	(35,777)	(37,817)	(37,972)	R-6	(45,049)
Appraisal increase	18,677	19,742	16,470	1.198	19,731
Total	$ 85,493	$ 90,366	$ 69,661		$ 83,218
Cash surrender value of life insurance	$ 3,650	$ 3,858	$ 1,738	(3)	$ 1,738
Total assets	$ 109,084	$ 115,302	$ 89,934		$ 103,539
Liabilities:					
Current liabilities	$ 29,172	$ 30,835	$ 16,460	(3)	$ 16,460
Deferred income	1,769	1,870	1,301	R-7	1,368
Long-term debt	24,576	25,977	35,199	(3)	35,199
Total liabilities	$ 55,517	$ 58,682	$ 52,960		$ 53,027
Stockholders' equity:					
Capital stock	$ 62,495	$ 66,057	$ 45,110	1.198	$ 54,042
Retained earnings	(8,928)	(9,437)	(8,136)		(3,530)
	$ 53,567	$ 56,620	$ 36,974		$ 50,512
	$ 109,084	$ 115,302	$ 89,934		$ 103,539

(1) From R-2 of 12/31/68. (2) Each item "rolled-forward" from 12/31/68 $s to 12/31/69 $s by using conversion factor for the last quarter of 1968—1.057. (3) Monetary items—no restatement needed.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
WORKING STATEMENTS OF INCOME AND RETAINED EARNINGS

	1968		1969		
	Restated to 12/31/68 $s (1)	Restated to 12/31/69 $s (2)	Historical	Conversion factor or source	Restated to 12/31/69 $s
Sales	$ 123,421	$ 130,456	$ 126,043	R-8	$ 128,532
Operating expenses:					
Depreciation	$ 7,473	$ 7,899	$ 6,452	R-6	$ 7,571
Other expenses	128,531	135,858	124,963	R-9	127,426
	$ 136,004	$ 143,757	$ 131,415		$ 134,997
Operating profit (loss)	$ (12,583)	$ (13,301)	$ (5,372)		$ (6,465)
Gain on sale of equipment			$ 6,766	(3) 1.025	$ 6,935
General price-level gain	$ 1,149	$ 1,214			$ 3,583
	$ 1,149	$ 1,214	$ 6,766		$ 10,518
Income (loss) before taxes	$ (11,434)	$ (12,087)	$ 1,394		$ 4,053
Montana corporation tax	10	10	220	1.019	224
Net income (loss)	$ (11,444)	$ (12,097)	$ 1,174		$ 3,829
Retained earnings—beginning	1,067	1,128	(11,350)	R-2	(9,437)
	$ (10,377)	$ (10,969)	$ (10,176)		$ (5,608)
Federal tax refund	242	256			
Increase in cash surrender value of life insurance	1,207	1,276	2,040		2,078
Retained earnings—end	$ (8,928)	$ (9,437)	$ (8,136)		$ (3,530)

(1) From R-3 of 12/31/68. (2) Each item "rolled forward" from 12/31/68 $s to 12/31/69 $s by using conversion factor for the last quarter of 1968—1.057. (3) Equipment fully depreciated out and not on books; sold during 2nd quarter when factor was 1.025.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
ANALYSIS OF PREPAID EXPENSES

12/31/69
R-4

Year acq.	Factor to restate 1969 addi.	Historical: Balance 12/31/68	Historical: Addit.	Historical: Amort.	Historical: Balance 12/31/69	Balance 12/31/68 in 12/31/68 $s (1)	Restated to 12/31/69 $s: Balance 12/31/68 (2)	Restated: Addit.	Restated: Amort.	Restated: Balance 12/31/69
1967		480		480		511	540		(3) 540	
1968 1st q.		801		435	366	824	871		(3) 473	398
1969 1st q.	1.039		842	420	422			874	436	438
		1,281	842	1,335	788	1,335	1,411	874	1,449	836

(1) From R-4 of 12/31/68. (2) Each item restated by factor for 4th quarter of 1968—1.057. (3) Restated amortization is same percentage of restated 12/31/68 balance as historical amortization is of historical 12/31/68 balance.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
ANALYSIS OF PLANT, PROPERTY, AND EQUIPMENT

12/31/69
R-5

Year acq.	Factor to restate 1969 addi.	Historical: Balance 12/31/68	Historical: Addit.	Historical: Retir.	Historical: Balance 12/31/69	Balance 12/31/68 in 12/31/68 $s (1)	Restated to 12/31/69 $s: Balance 12/31/68 (2)	Restated: Addit.	Restated: Retir.	Restated: Balance 12/31/69
1964		72,180		283	71,897	81,852	86,518		339	86,179
1965		13,566			13,566	15,114	15,975			15,975
1966		3,600			3,600	3,902	4,124			4,124
1968 1st q.		1,676			1,676	1,725	1,823			1,823
1969 2nd q.	1.025		424		424			435		435
		91,022	424	283	91,163	102,593	108,440	435	339	108,536

(1) From R-5 of 12/31/68. (2) Restated to 12/31/69 $s by factor for 4th quarter of 1968—1.057. (3) Restated retirement amount is same percentage of restated 12/31/68 balance as historical retirement amount is of historical 12/31/68 balance.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
ANALYSIS OF ACCUMULATED DEPRECIATION

12/31/69
R-6

		Historical				Balance	Restated to 12/31/69 $s			
Year acq.	Factor to restate to 12/31/69 $s	Balance 12/31/68	Deprec. (1)	Retir.	Balance 12/31/69	12/31/68 in 12/31/68 $s (2)	Balance 12/31/68 (4)	Deprec. (1)	Retir.	Balance 12/31/69
1964		22,460	3,535	283	25,712	25,469	26,921	4,235	(3) 339	30,817
1965		7,228	1,506		8,734	8,052	8,511	1,773		10,284
1966		1,439	512		1,951	1,560	1,649	587		2,236
1968										
1st q.		676	865		1,541	696	736	941		1,677
1969										
2nd q.	1.025		34		34			35		35
		31,803	6,452	283	37,972	35,777	37,817	7,571	339	45,049

(1) Depreciation at various rates. (2) From R-6 of 12/31/68. (3) Restated accumulated depreciation on assets retired is same percentage of restated 12/31/68 balance as historical accumulated depreciation on retirements is of historical 12/31/68 balance. (4) Restated to 12/31/69 $s by factor for 4th quarter of 1968—1.057.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
ANALYSIS OF DEFERRED INCOME

12/31/69
R-7

		Historical				Balance	Restated to 12/31/69 $s			
Year acq.	Factor to restate to 12/31/69 $s	Balance 12/31/68	Addit.	Realiz.	Balance 12/31/69	12/31/68 in 12/31/68 $s (1)	Balance 12/31/68 (2)	Addit.	Realiz.	Balance 12/31/69
1968										
1st q.		1,719		1,369	350	1,769	1,870		(3)1,489	381
1969										
1st q.	1.038		951		951			987		987
		1,719	951	1,369	1,301	1,769	1,870	987	1,489	1,368

(1) From R-7 of 12/31/68. (2) Each item restated by factor for 4th quarter of 1968—1.057. (3) Restated realized income is same percentage of restated 12/31/68 balance as historical realized income is of historical 12/31/68 balance.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
ANALYSIS OF SALES

12/31/69
R-8

	Historical	Conversion factor or source	Restated to 12/31/69 $s
Sales:			
Current sales	124,674	(1) 1.019	127,043
Deferred sales realized	1,369	R-7	1,489
	126,043		128,532

(1) Spread fairly evenly throughout the year.

XYZ COMPANY
GENERAL PRICE-LEVEL RESTATEMENT—1969
ANALYSIS OF EXPENSES

12/31/69
R-9

	Historical	Conversion factor or source	Restated to 12/31/69 $s
Amortization of prepaid expenses	1,335	R-4	1,449
Other expenses	123,628	(1) 1.019	125,977
	124,963		127,426

(1) Spread fairly evenly throughout the year.

12/31/69
R-10

XYZ COMPANY

GENERAL PRICE-LEVEL RESTATEMENT—1969

GENERAL PRICE-LEVEL GAIN OR LOSS

		12/31/68		12/31/69
	Source	Historical	Restated to 12/31/68 $s	Historical stated in 12/31/69 $s
Net monetary items:				
Cash	R-2	$ —	$ —	$ 1,961
Receivables	R-2	18,606	19,667	15,786
Cash surrender value of life insurance	R-2	3,650	3,858	1,738
Current liabilities	R-2	(29,172)	(30,835)	(16,460)
Long-term debt	R-2	(24,576)	(25,977)	(35,199)
		$ (31,492)	$ (33,287)	$ (32,174)

	Historical	Source	Restated to 12/31/69 $s
General price-level gain or loss			
Net monetary items—12/31/68	$ (31,492)	as above	$ (33,287)
Add:			
Current sales	124,674	R-8	127,043
Additions to deferred income	952	R-7	987
Proceeds from sale of equip.	6,766	R-3	6,935
Increase in cash surrender value of life insurance	2,040	R-3	2,078
	$ 102,940		$ 103,756
Deduct:			
Expenses	$ 123,628	R-9	$ 125,977
Montana corporation tax	220	R-3	224
Purchase of equipment	424	R-5	435
Additions to prepaid expense	842	R-4	874
Purchase of treasury stock	10,000	1.198	12,003
	$ 135,114		$ 139,513
Net monetary items—historical 12/31/69 (as above)	$ (32,174)		
Net monetary items—restated 12/31/69 (if there was no gain)			$ (35,757)
Net monetary items—12/31/69			$ (32,174)
General price-level gain			$ 3,583

CHAPTER IV

SUMMARY

INTRODUCTION

Research has been presented to show the need for more meaningful financial statements. One method of furnishing this information has been presented and recommended. The conventional historical cost statements and the supplementary price-level adjusted statements, along with comparative ratios and an analysis of financial statements, were presented to the business owner and to a local financier. A group of questions was prepared and asked of both parties to determine their reactions (see Appendix A). The comparative ratios and analysis of financial statements are included in the discussion to follow. Conclusions will be drawn from this information.

APPLICATION OF RATIOS AND ANALYSIS OF FINANCIAL STATEMENTS

RATIO	HISTORICAL COST STATEMENTS	GENERAL PRICE-LEVEL STATEMENTS
Current ratio		
1968	.68 to 1	.68 to 1
1969	1.1 to 1	1.1 to 1
Plant & equipment to long-term debt		
1968	2.4 to 1	2.7 to 1
1969	1.5 to 1	1.8 to 1

RATIO	HISTORICAL COST STATEMENTS	GENERAL PRICE-LEVEL STATEMENTS
Accounts receivable turnover		
1968	6.8 to 1	6.8 to 1
1969	7.3 to 1	7.3 to 1
Stockholders' equity to total liabilities		
1968	.69 to 1	.96 to 1
1969	.79 to 1	.97 to 1

Upon examining the financial statements of the XYZ Company, one thing is readily apparent. The company was not doing well financially. In reviewing Exhibit A, page 36, the conventional balance sheet tells the story. Retained earnings showed a $11,350 deficit in 1968 and a $8,136 deficit in 1969. Application of the current ratio shows .68 to 1 in 1968 and 1.1 to 1 in 1969. This indicates an undesirable situation when one takes into account that normally the current ratio should not fall below 2 to 1. Another indication of the poor financial condition is the ratio of stockholders' equity to total liabilities. In 1968 it was .69 to 1 and in 1969 there was slight improvement at .79 to 1.

The conventional statement of income and retained earnings in Exhibit B, page 37, indicates similar financial problems. During 1968 the company experienced a net loss of $11,729. In 1969 it appeared that the company experienced more success, but a closer examination shows that this was due to a non-recurring gain on the sale of equipment. It continued to show an operating loss of $5,372.

The general price-level balance sheet for 1968 in Exhibit C, page 39, reports a little better financial condition than that which is shown in Exhibit A. The main reason for this is the revaluing of plant, property, and equipment in terms of general purchasing power and paying off liabilities in current dollars. This is indicated by the ratio of plant and equipment to long-term debt of 2.7 to 1 in 1968 as compared to the conventional statements ratio of 2.4 to 1. In 1969 these ratios were 1.8 to 1 as compared to 1.5 to 1. In 1968 the ratio of stockholders' equity to total liabilities was .96 to 1 in the general price-level balance sheet as compared to .69 to 1 in the conventional balance sheet. In 1969 these same two ratios were .97 to 1 as compared to .79 to 1. This would indicate that the elements which make up retained earnings have been revalued for general purchasing power, whereas the liabilities will be paid off in current dollars.

An examination of Exhibit D, page 40, will indicate why there is a considerable difference between the conventional statement of income and retained earnings and the adjusted statement. The two main factors are the general price-level gain computed in schedule R-10 on page 49 and the restated retained earnings at the beginning of the year.

The XYZ Company experienced a better year in 1969. It reported net income in both the conventional statements and the adjusted statements due primarily to the gain on sale of equipment. As in 1968, the general price-level statements exhibited a better financial picture than did the conventional statements.

In analyzing the over-all picture of the financial condition of the XYZ Company, one generalization might be made. This particular company appeared to benefit from inflation. It was in serious financial condition but through extended credit was able to "hang on" by borrowing current dollars and repaying them in cheaper dollars at a later date.

This company is one example of a business which lost little through holding monetary assets and which gained by operating on credit.

CONCLUSION

Inflation is a serious problem today. One need only read the newspaper or listen to a news report to learn how our government is trying to curb inflation. Since 1972 and the first half of 1973, the problem has become critical to the point where the federal government has imposed a wage-price freeze. With inflation of this magnitude, the accounting profession cannot ignore the need for consistency in financial reporting.

It was mentioned earlier that general conclusions cannot be drawn from one set of adjusted statements or from the reaction of one owner or one financier. However, the general price-level adjusted statements of the XYZ Company do show the effects of inflation on this particular business. As was pointed out earlier, the business did appear to benefit from inflation due to operating on extended credit. Most authorities agree that borrowers generally benefit during periods of inflation. The owner of the business and the banker both agreed that the supplementary statements were of value and gave them a clearer picture as to what progress the business was making. It also gave them a better understanding of the effects of inflation and, with this knowledge, they felt they could better cope with it in the future. The fact that these two respondents felt the presentation was of value to them would be an indication that the study was worthwhile and that further research should be done along this line.

The profession must continue to search for methods to present more useful information to management, lenders, and investors. It is believed that the method recommended in this paper is a good start and, through further research and study, could be expanded upon until inflation is no longer a serious problem in financial-statement reporting.

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APPENDIX A

PERSONAL INTERVIEW QUESTIONNAIRE

The purpose of this personal interview was to determine the reaction of management or lender to the removal of inflation from the dollar in financial statements and if placing comparative statements on a common-dollar basis could be of any value to the reader.

The financial statements in Exhibits A, B, C, D, E, and F were presented to the owner of the XYZ Company and a banker. Before the respondents studied the financial statements, it was explained to them how inflation can affect a business and its financial statements. This explanation included such things as:

1. It is costly to hold monetary assets.
2. Bonds, insurance policies, and annuities shrink in value.
3. To hold tangible property generally benefits a business.
4. Debtors generally benefit because they pay back their debts in cheaper dollars than they acquired.
5. It takes more collars to conduct the same operations.
6. Inventory ties up more dollars than previously.
7. It requires more dollars to finance customers accounts.
8. It will take more dollars to finance replacement of plant facilities than are currently being charged against income in the form of depreciation.
9. It is difficult to obtain a good comparison between years when you are comparing dollars of different values.
10. There is actually a loss in purchasing power of monetary assets which should be disclosed.

After the readers had ample time to study the statements, the following questions were asked:

Question: Do you understand what is being done?

The readers of the statements appeared at first to be confused with the whole process. However, after it was explained how inflation affects a business and its financial statements and how this particular business was affected by inflation, they realized the problem that inflation does present. They felt their understanding of general price-level adjusted financial statements was sufficient to determine if the statements could be of value to them individually.

Question: Were you aware of these recommendations of the AICPA?

Neither party was aware that the accounting profession was trying to overcome the problem of inflation in comparative financial statements.

Question: Do you have any comments with regard to the loss of purchasing power on monetary assets?

The readers were aware that purchasing power is lost during periods of inflation but were amazed at the effect it had on the financial statements. The owner of the business felt he couldn't afford to have an excess of cash or accounts receivable on the books. He commented if he were to take any excess cash and deposit it in a savings account or buy CDs, the interest earned might balance off the loss due to holding monetary assets. He also mentioned that he now realized he not only stood to lose in bad debts due to allowing his accounts receivable to slide, but also faced a loss due to price-level changes.

Question: Do you feel the information furnished gives you a better picture of the progress of your business?

The owner of the business was quite excited about the presentation. He stated that previously his primary interest was whether the business was showing a profit or a loss. He didn't feel that he had a functional understanding of the financial statements. He felt that now he could read the statements with a better understanding and determine what areas needed improvement.

Question: If you were previously unaware of the effects of inflation on your business, do you feel that with this knowledge you can do a better job of operating your business?

The owners felt that the supplementary statements were actually of more value to them in analyzing the progress of the business than the historical cost statements.

Question: Do you feel that inflation in the United States is serious enough to warrant adjusting financial statements?

Both readers felt inflation was a serious problem in the economy but didn't realize the effect it had on a business and financial statements. They felt that any amount of inflation was serious enough to warrant adjusting financial statements for comparison purposes.

Question: Do you feel that any other method of adjusting financial statements might be better; such as replacement cost, current value, or future net receipts?

Both parties were somewhat concerned about the use of any type of adjustments which might be based on subjective estimates. The owner of the business felt that there might be some value in the use of these methods in internal planning such as replacement cost for use in expansion or updating equipment or current value for liquidation purposes. However, he believed that for external reporting and the normal operation of the business historical cost statements adjusted for general purchasing power were more valuable. The banker was more emphatic in his feelings toward the use of some other form of adjusting. He thought more along the line of what happened prior to the depression with the use of different types of replacement cost accounting. He also felt adjusted historical cost statements were the answer.

Question: Do you have any ideas which could help the accounting profession to give management a better set of financial statements?

Both parties were in agreement that the more information received the better and that all parts of the financial statements should be explained thoroughly through the use of footnotes or other explanations so that the average businessman, investor, and lender could get a more complete picture of the business. In addition, they believed it would be a great help if an analysis of the financial statement showing areas where improvements might be made in the business operation were furnished.

Question: Do you feel the accounting profession in Montana is keeping up to date?

In the area of auditing and preparing financial statements for income tax purposes, they felt the accounting profession in Montana was doing an adequate job. However, their combined opinion was that a great deal more information is needed which could be furnished to aid the owner in the operation of his business.

<u>Question</u>: Would management prefer price-level adjusted statements as a supplement to conventional ones or would they prefer:
(a) Price-level adjusted statements alone?
(b) Continued use of conventional statements alone?

Management preferred the use of the historical cost statements supplemented by price-level adjusted statements. Both parties agreed that until there are revisions in the income tax laws which would accept price-level adjustments and until a method might be found which would give more objective and verifiable evidence, historical cost statements were still a necessity.