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THE EVOLUTION OF INFLATION ACCOUNTING IN THE U.S.

by

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Statement of Financial Accounting Standards (SFAS) No. 33, *Financial Reporting and Changing Prices* was issued in December 1979 and an experiment with reporting the effects of price-level changes began. Seven years later, in December 1986, the experiment was ended with the issuance of SFAS No. 89. This statement made the provision of supplementary price-level adjusted information voluntary.

SFAS No. 89 was not the result of hasty deliberation. To the contrary, the statement was the result of a continuing process of review by the Financial Accounting Standards Board (FASB). An analysis of the evolutionary process of inflation accounting reveals the cognitive, continuous character of the FASB's attitude toward this problem of accounting for changing prices.

This article presents a discussion of the development of the need for inflation accounting, the history of official pronouncements addressing inflation accounting, and a summary of research studies dealing with reporting the effects of changing prices. Not only does this analysis reveal the continuity, depth, and complexity of the issues facing the FASB, but it also facilitates an understanding of how and why the FASB determined that presentation of supplementary price-level adjusted information should be voluntary.

The Evolution

Early Evolution

The need for inflation accounting was first addressed by Baver [1919], Paton [1920], Sweeney [1936] and others in the 1920's and 1930's. Inflation was not an accounting problem during this period of U.S. history; therefore, research data were not readily available. Sweeney [1936], the major contributor to the concept of inflation accounting, analyzed the problems of valuation in relation to inflation that existed in Germany in the 1920's.

Sweeney's research findings on accounting for the effects of inflation enabled him to develop "stabilized" accounting procedures for preparing price-level adjusted information. Sweeney recognized a need for price-level adjusted information in two distinct areas. First, he recognized a need for providing information concerning the effects of changes in the general price level. Second, Sweeney recognized an exigency for information concerning realized appreciation in value that is distinct from the increase in the general level of prices. Sweeney concluded that "stabilized" accounting information is important, but not so important that it should replace historical cost information. Sweeney suggested that the presentation of the "stabilized" information be limited to...
presentation in memorandum form only [Sweeney, 1936].

1938-1958 — Committee on Accounting Procedure

Since inflation was not a problem in the U.S. during the time period that Sweeney developed his theories of inflation accounting, his ideas were not readily accepted. Interest in the problem of accounting for inflation remained dormant until after World War II. Inflation increased during World War II and in the immediate post-war period. The Committee on Accounting Procedure (CAP) concluded in Accounting Research Bulletin (ARB) No. 33, Depreciation and High Costs [1947], that no accounting change was needed to reflect the effects of the decline in the purchasing power of the dollar. The CAP stated:

The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time [CAP, 1947].

C. Oliver Wellington was the only member who assented with qualification. He felt that inflation was already at a level to require recognition (CAP, 1947). When issued, ARB No. 43 [1953] reaffirmed with a vote of 14-6 that no accounting change was needed at the time.

1959-1972 — Accounting Principles Board

Unexpectedly, however, the prices after World War II continued to rise not only in the following decade but for the following three-and-a-half decades. The rates of inflation (CPI, from the Economic Report of the President, February, 1986) for specific years from 1952 through 1986 are shown in Figure 1 along with the accounting pronouncements related to price-level adjustments.

The rate of inflation in 1950 was .98 percent and by 1960 inflation had reached 1.60 percent. It became apparent to the Accounting Principles Board (APB) that inflation would continue to increase. Therefore, in a special 1961 meeting, the APB concluded that ignoring fluctuations in the monetary unit was no longer realistic (Staff of the Accounting Research Division, 1963). In response, a special committee, led by Maurice Moonitz, was formed to address the perennial problem of inflation. Subsequently, the recognition of a need for accounting for the effects of fluctuations in the value of the monetary unit was emphasized in Accounting Research Study (ARS) No. 3, A Tentative Set of Broad Accounting Principles for Business Enterprises. Robert T. Sprouse and Maurice Moonitz, the authors of ARS No. 3, commented

...we are in agreement with the Board that the assumption in accounting that fluctuations in the value of the dollar may be ignored is unrealistic... Furthermore, because a separate study is under way to explore the price-level problem, we have not, in this study, given any detailed attention to its impact on accounting [Sprouse and Moonitz, 1962, p. 17].

Carman Blough, a member of the committee which reviewed the work on ARS No. 3, pointed out further that the Board suggested that if any price-level adjustments were to be made they should appear only in supplementary statements, not in the financial statements. Blough's opinion was that the lack of evidence in the application of the 'principles' that would be applied in adjusting for the effects of price-level changes was not sufficient to require a change at that time [Sprouse and Moonitz, 1962].

In 1963, the recognition of the effects of fluctuations on the value of the monetary unit was reemphasized in ARS
Significant Pronouncements Related to Price-Level Adjustments

1. 1953 ARB No. 43 "Restatement and Revision of ARBs No. 1-42"
2. 1962 ARS No. 3 "A Tentative Set of Broad Accounting Principles for Business Enterprises"
3. 1963 ARS No. 6 "Reporting the Effects of Price-Level Changes"
4. 1969 APB Stmt. No. 3 "Financial Statements Restated for General Price-Level Changes"
5. 1974 FASB DM "Reporting the Effects of General Price-Level Changes in Financial Statements"
6. 1974 FASB ED "Financial Reporting in Units of General Purchasing Power"
7. 1976 SEC ASR No. 190 "Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data"
8. 1978 FASB ED "Financial Reporting and Changing Prices"
9. 1979 FASB ED "Constant Dollar Accounting"
10. 1979 SFAS No. 33 "Financial Reporting and Changing Prices"
11. 1984 SFAS No. 82 "Financial Reporting and Changing Prices: Current Cost Information"
12. 1986 SFAS No. 89 "Financial Reporting and Changing Prices"
No. 6. ARS No. 6, Reporting the Effects of Price-Level Changes, (Staff of the Accounting Research Division, 1963) is a proposal that adjustments for price-level changes make financial statements more accurate and beneficial to users. Incorporated in ARS No. 6 were Sweeney’s “stabilized” accounting procedures.

ARS No. 6 presented actual cases and literature which showed the need for financial statements to reflect the effects of price-level changes and also demonstrated that recognition of the effects could be implemented. The 24 companies which actually provided price-level information included Reece Corporation, Philips Industries, Indiana Telephone Corporation, Hercules Powder Company, Eastman Kodak Company, and Iowa-Illinois Gas and Electric Company.

Based on the results of ARS No. 6, the APB issued Statement No. 3, Financial Statements Restated for General Price-Level Changes, in June 1969. In this statement, the APB recommended that if entities provide supplementary general price-level information they should apply the Gross National Product (GNP) deflator. The GNP deflator had also been suggested for use in ARS No. 6.

1972-1986—The Financial Accounting Standards Board (FASB)

The rate of inflation continued to increase from 2.86 percent in 1966 to 10.97 percent in 1974. With the occurrence of this continuous, rapidly-increasing inflation, the accounting community became even more concerned with the problem of accounting for the effects of price changes. A major issue was whether APB Statement No. 3’s suggestions were an adequate solution to accounting for the effects of inflation. With the rate of inflation increasing, should accounting for inflation be made mandatory?

In February 1974 in response to this question, the FASB issued a discussion memorandum, Reporting the Effects of General Price-Level Changes in Financial Statements, which addressed the problems caused by inflation. As Edwards and Warren [1975] note, the primary issue raised in the memorandum was whether the traditional historical-dollar financial statements should include supplemental information on the effects of price-level changes. Other issues addressed included which entities should be required to present price-level adjusted statements and what restatement techniques should be used. The responses to the memorandum were mixed. Most of the responses from industry indicated opposition to mandatory reporting of price-level restatements. Academicians strongly favored mandatory price-level restatements. Although less emphatic than those in academics, the majority of responses from accounting firms supported mandatory disclosure. One major concern seemed to center around the confusion that might ensue if users misinterpreted general purchasing power as being indicative of current values.

Based on the memorandum and the responses to it, an exposure draft, Financial Reporting in Units of General Purchasing Power, was issued in December 1974. The primary conclusion in the exposure draft was that the financial statements of all companies should include a supplementary comprehensive restatement in units of general purchasing power. The FASB arrived at this conclusion for several reasons. First, the Board thought that constant-dollar accounting would enable users to evaluate the changing value of the dollar on individual enterprises. Second, it was believed that constant-dollar accounting would facilitate interperiod comparisons. Third, gains and losses from holding monetary assets and liabilities could be shown. Fourth, it was of the opinion that a required restatement
by the companies was preferable to the potentially misleading restatements that were being attempted by users. Concerning the potential confusion of misinterpreting general purchasing power information as indicative of current value, the FASB stated that this could be avoided if firms exercised care in presenting and explaining the constant dollar information in their financial statements.

The provisions of the 1974 exposure draft were never finalized in the form of an accounting standard. The FASB delayed its work in this area until an in-progress field study dealing with the effects of changing prices was completed and the results analyzed. This field study was completed in May 1977.

Two other factors also slowed the FASB's progress in developing standards for reporting the effects of inflation. First, in March 1976, the Securities and Exchange Commission (SEC) issued Accounting Series Release (ASR) No. 190, "Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data". In this release, the SEC required that certain public companies provide supplementary replacement cost data. The FASB deferred action partially in consideration of the fact that certain large companies were already required to use resources to provide current replacement cost information per ASR No. 190 [FASB, 1979b].

Second, the Board postponed its efforts to solve the problems of reporting the effects of inflation until SFAC No. 1, Objectives of Financial Reporting by Business Enterprises, was fully developed. SFAC No. 1 would serve as a guide in formulating solutions concerning accounting for changing price levels [FASB, 1979].

SFAC No. 1 was issued in November 1978, and the FASB rekindled its efforts toward providing guidance on reporting the effects of inflation. The exposure draft, Financial Reporting and Changing Prices, was issued in December 1978. Subsequently, a second exposure draft, Constant Dollar Accounting, was issued in March 1979. Both exposure drafts were proposed guidance in reporting constant dollar information as recommended in the 1974 exposure draft. Some of the more significant changes made to the 1974 proposal included a move away from comprehensive restatement to partial restatement for selected data, and the usage of the Consumer Price Index for all urban consumers (CPI(U)) rather than the GNP deflator.

Following the issuance of the 1978 exposure draft, the FASB established six special industry task groups and held public hearings. The special industry task groups were formed because the FASB recognized that its exposure drafts were general in nature and could not address the problems that would be encountered in measuring the effects of price changes in specific industries. For example, in the forest products industry the Task Group cited one unique implementation problem area—timberlands and standing timber, which is a resource covering a long and indefinite time period. Many of these special problems had already been identified through the attempts to apply ASR No. 190 [Griffin, 1979]. The six industries identified as possessing unique characteristics were banking, insurance, mining, oil and gas, real estate, and forest products.

Communications with the public as well as information provided by the industry task groups were considered by the FASB in reaching the final conclusions concerning the exposure drafts. The FASB's efforts resulted in the issuance of SFAS No. 33, Financial Reporting and Changing Prices, in September, 1979. The objectives contained in the statement were based on objectives as set forth in SFAC No. 1. SFAC No. 1 purported that the information pro-
vided in financial statements should be beneficial to users in the assessment of cash flows. As proposed in Sweeney's "stabilized" accounting procedures, two types of provisions were required to increase the usefulness of financial statements. Both general purchasing power changes (i.e., constant dollar data) and specific price changes (i.e., current cost data) were to be reported by certain large companies. Also, in replication of Sweeney's idea to present the price-level adjusted information in memorandum form, the effects of price changes were to be presented as a supplement to historical cost information.

In light of the conflicting opinions received in response to the exposure draft, the FASB decided that the statement should be flexible in nature. In some of the comments from respondents, the importance of reporting the effects of general price changes was emphasized. Other respondents stressed a need for information on changes in specific prices [SFAS No. 33, 1979, para. 110-115]. As a result, the FASB planned a follow-up review of the results of reporting to determine not only if price-level adjusted data are useful, but which of the two methods (current cost or constant dollar) is more useful. Ultimately the review would be utilized to determine if price-level adjusted data should continue to be reported, and if so, which reporting method should be required.

RESEARCH RESULTS—1980-1985

The FASB issued SFAS No. 33 as a unique experiment and committed itself to review the results of this experiment. However, prior to SFAS No. 33, at least 23 studies had been performed which examined the usefulness of price-level adjusted data. Most of these earlier studies found that price-level adjusted data were not considered useful. Of these 23 studies, 15 reported that price-level adjusted information was not useful, three indicated price-level adjusted information appeared useful, and five reported no definite conclusions.

The research studies performed subsequent to the issuance of SFAS No. 33 were undertaken to provide the FASB with additional evidence on the usefulness of price-level adjusted data. These later studies were particularly important because they examined information prepared according to SFAS No. 33 guidelines. During the six-year period following the issuance of SFAS No. 33, at least 27 studies were conducted to investigate the usefulness of price-level adjusted information. Table 1 summarizes the details and conclusions of these 27 studies.

Almost one-half of the studies performed subsequent to the issuance of SFAS No. 33 reported that financial information adjusted for the effects of changing prices was not useful. About one-fourth of the studies indicated that price-level adjusted information was useful while the remaining studies proved inconclusive.

Twelve of the 27 studies compared the usefulness of both current cost data and constant dollar data. As already mentioned, one of the major purposes of the FASB's review of research was to determine which was more useful—current cost data or constant dollar data. Although the results of these studies were not highly conclusive, the studies appeared to indicate that current cost data were more useful than constant dollar data.

The FASB's Response to the Research Results

During the FASB's examination of the application of SFAS No. 33 requirements, several specific problem areas became apparent. These problems occurred for companies in certain industries, including mining and oil, gas, timberlands and...
<table>
<thead>
<tr>
<th>Date</th>
<th>Author(s)</th>
<th>Details of the Study</th>
<th>Price-Adjusted Data Are Useful</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>Baran et. al.</td>
<td>Capital market study that tested the association of market betas and accounting betas</td>
<td>YES</td>
</tr>
<tr>
<td></td>
<td></td>
<td>with HC and CD data.</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>Baran et. al.</td>
<td>Predicted bond ratings with a discriminant analysis model using HC and CD data.</td>
<td>YES</td>
</tr>
<tr>
<td>1980</td>
<td>Beaver et. al.</td>
<td>Capital market study of the reaction of stock prices to CC data.</td>
<td>NO</td>
</tr>
<tr>
<td>1980</td>
<td>Cooper</td>
<td>Capital market study of the correlation between CC data and measures of beta</td>
<td>YES</td>
</tr>
<tr>
<td>1980</td>
<td>Friedman et. al.</td>
<td>Capital market study of changes in stock prices in relation to CC data.</td>
<td>YES</td>
</tr>
<tr>
<td>1980</td>
<td>Gheyara &amp; Boatsman</td>
<td>Capital market study testing for abnormal returns in reaction to ASR 190 data.</td>
<td>NO</td>
</tr>
<tr>
<td>1980</td>
<td>Harris</td>
<td>Interview and survey of financial officers, analysts press representatives, academicians, government officials, accountants, and executives concerning their view of CC and CD data.</td>
<td>NO-CD</td>
</tr>
<tr>
<td>1980</td>
<td>Kelly-Newton</td>
<td>Behavioral study using content analysis to analyze ASR 190 footnote disclosures.</td>
<td>INCON</td>
</tr>
<tr>
<td>1980</td>
<td>Ro</td>
<td>Capital market study examining the reaction of stock prices to ASR 190 data.</td>
<td>NO</td>
</tr>
<tr>
<td>1980</td>
<td>Stone</td>
<td>Lab study of students making investment decisions with either HC or CC data.</td>
<td>NO</td>
</tr>
<tr>
<td>1981</td>
<td>Beaver et. al.</td>
<td>Capital market study that measured security returns in relation to two measures of income, HC income and CC income.</td>
<td>NO</td>
</tr>
<tr>
<td>1981</td>
<td>Casey &amp; Sandretto</td>
<td>Survey of controllers to determine the usefulness of CD data in making decisions.</td>
<td>INCON</td>
</tr>
<tr>
<td>1981</td>
<td>Grossman et. al.</td>
<td>Tested the reactions of the market to ASR 190 data. Partitioned data according to the decrease in income resulting from an adjustment from HC data to CC data.</td>
<td>YES</td>
</tr>
<tr>
<td>1981</td>
<td>Noreen &amp; Sepe</td>
<td>Capital market study of 3 events related to the FASB's proposed adoption of CD disclosure.</td>
<td>YES</td>
</tr>
<tr>
<td>1981</td>
<td>Schwarzbach &amp; Swanson</td>
<td>Survey of controllers concerning providing CC information to managers.</td>
<td>INCON</td>
</tr>
<tr>
<td>1982</td>
<td>Beaver &amp; Landsman</td>
<td>Capital market study of the relationship between stock prices and CC and CD income.</td>
<td>NO</td>
</tr>
<tr>
<td>Year</td>
<td>Authors</td>
<td>Summary</td>
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<tr>
<td>1983</td>
<td>Bar-Yosef &amp; Lev</td>
<td>Capital market study that examined the relationship between dividends and measures of earnings, including CC and CD earnings.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Bartley &amp; Boardman</td>
<td>Examined the relationships between CC and CD data and investment takeover targets.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Berliner</td>
<td>Survey of financial officers’ views concerning SFAS No. 33 data.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Brown</td>
<td>Survey of financial analysts concerning the usefulness of CC and CD data.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Flesher &amp; Soroosh</td>
<td>Survey of CFAs and controllers concerning the reliability and usefulness of CD and CC data.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Freeman</td>
<td>Capital market study of the relationship between security returns and CC data.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Norby</td>
<td>Survey of financial analysts and managers concerning their use of CC and CD data.</td>
<td></td>
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<tr>
<td>1983</td>
<td>Perry &amp; Searfoss</td>
<td>Survey of managers concerning the usefulness of CC and CD data for making decisions.</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>Vasarhelyi</td>
<td>Examined the relationships between CC and CD data and shareholder value.</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td>McDonald &amp; Morris</td>
<td>Cross-sectional market study of the relationship between security returns and SFAS 33 data.</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>Rosenzweig</td>
<td>Survey of controllers’ use and reporting of CC and CD data. Uses included adjustment of insurance coverage, capital investment decisions, product pricing, sales decisions, make-or-buy decisions, and determining cash dividends.</td>
<td></td>
</tr>
</tbody>
</table>
growing timber, income-producing real estate, motion picture films, and investment companies. These special problems were quickly addressed by the FASB in SFAS Nos. 39 [1980], 40 [1980], 41 [1980], 46 [1981], 54 [1982], 69 [1982], and 70 [1982]. These standards were very specific in nature and are, therefore, not discussed in detail.

The next standard which produced far-reaching results was SFAS No. 82. SFAS No. 82 Financial Reporting and Changing Prices: Elimination of Certain Disclosures was the FASB’s response to the research that had shown that current cost data appeared more useful. This statement eliminated the requirement for constant dollar information if the companies provided disclosure of current cost information. SFAS No. 82 was issued in November 1984, five years after the experiment with SFAS No. 33 had begun.

In December 1984, the FASB took another step in addressing the problems of reporting the effects of changing prices by issuing an exposure draft, Financial Reporting and Changing Prices: Current Cost Information. This exposure draft proposed consolidating all of the previously issued statements related to financial reporting and changing prices and was intended to be the culminating step in the saga of reporting the effects of price changes. However, due to unfavorable public response, the provisions of this exposure draft were never finalized into an accounting standard. Some comments from the public indicated that reported information adjusted for changing prices was not used by the institutional investment community, bankers, or investors. Other comments emphasized that the information was not understandable. The most frequently cited comment was that price-adjusted data was not cost-effective [FASB, 1986]. The price-level adjusted information had been evaluated by the public and was found lacking in the characteristics suggested by SFAC No. 1 (i.e., usefulness, understandability, and benefits exceeding costs). Since the price-level adjusted information lacked the desired characteristics, the FASB decided not to issue the new statement, but instead to move in a new direction as described below.

Although a large number of studies concluded that reporting the effects of changing prices was not useful, the FASB firmly believed that price-level adjusted information was useful, could be understandable, and could be presented in a cost-beneficial manner. The FASB thought the significance of price-level adjusted information would be apparent if alternate, improved methods of reporting the effects of changing prices could be developed. Consequently, a new project was started to formulate more effective and useful disclosures of price-level adjusted data [FASB, 1986a]. However, the project ended prematurely. An examination of inflation during the 1980’s reveals that it decreased from 13.52 percent in 1980, to 6.13 percent in 1982, and further to 1.90 percent in 1986. With a significantly reduced rate of inflation, the FASB decided that solving the reporting problems caused by changing prices should no longer consume its limited time and resources [FASB, 1986b].

In September 1986, the Board ratified this conclusion by issuing an exposure draft. In it they proposed elimination of the requirement that companies provide supplementary information adjusted for the effects of changing prices. This exposure draft was approved and finalized in December 1986. The result was SFAS No. 89, Financial Reporting and Changing Prices.

With the issuance of SFAS No. 89, presentation of financial information adjusted for price changes became voluntary.
The FASB statements dealing with financial reporting and changing prices were superceded by the issuance of this statement. These statements include SFAS No.s 33, 39, 40, 41, 46, 54, 69, 70 and 82. Although supplementary disclosure of the effects of changing prices is not required by SFAS No. 89, the FASB does encourage enterprises to disclose this information. Measurement and presentation guidelines for disclosure are provided in SFAS No. 89. The FASB believes that the SFAS No. 33 provisions are the best methods designed to date; consequently, the guidelines presented in SFAS No. 89 are based on SFAS No. 33 provisions as amended. However, enterprises are also allowed to experiment with other forms of disclosure.

**Conclusion**

The promulgation of authoritative pronouncements on reporting the effects of price changes appears to be directly related to the rate of inflation. SFAS No. 89 concludes the current chapter in the ongoing saga of accounting for the effects of price changes. However, if and when inflation becomes a significant problem again, future chapters will undoubtedly follow.

**References**


Baver, John, "Renewal of Costs and Business Profits in Relation to Rising Prices." Journal of Accountancy. 28 (December, 1919): 413-419.


