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An Analysis of the Effect of Changing Price Levels on Financial Statements

Robert Donald Clyde

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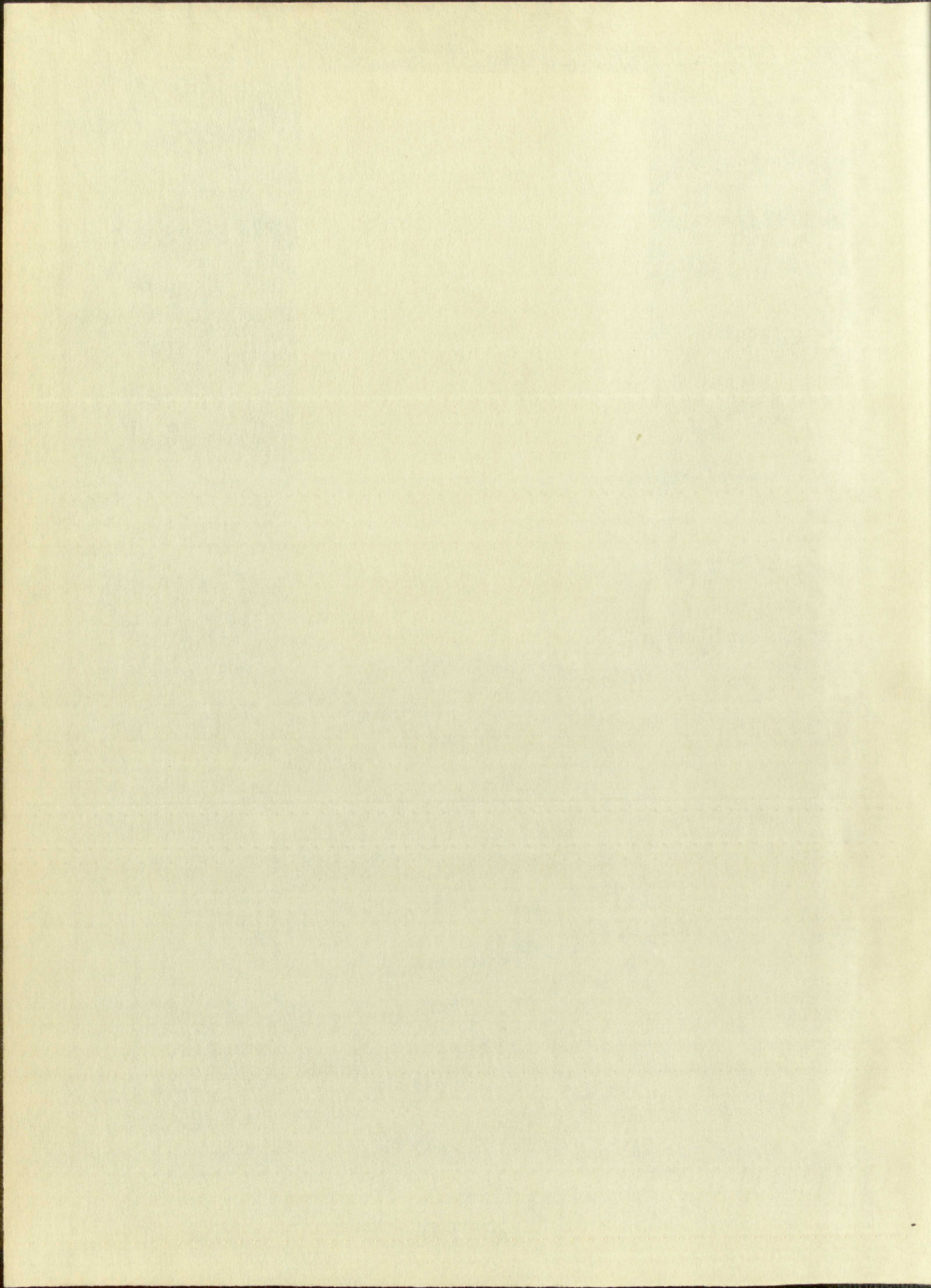
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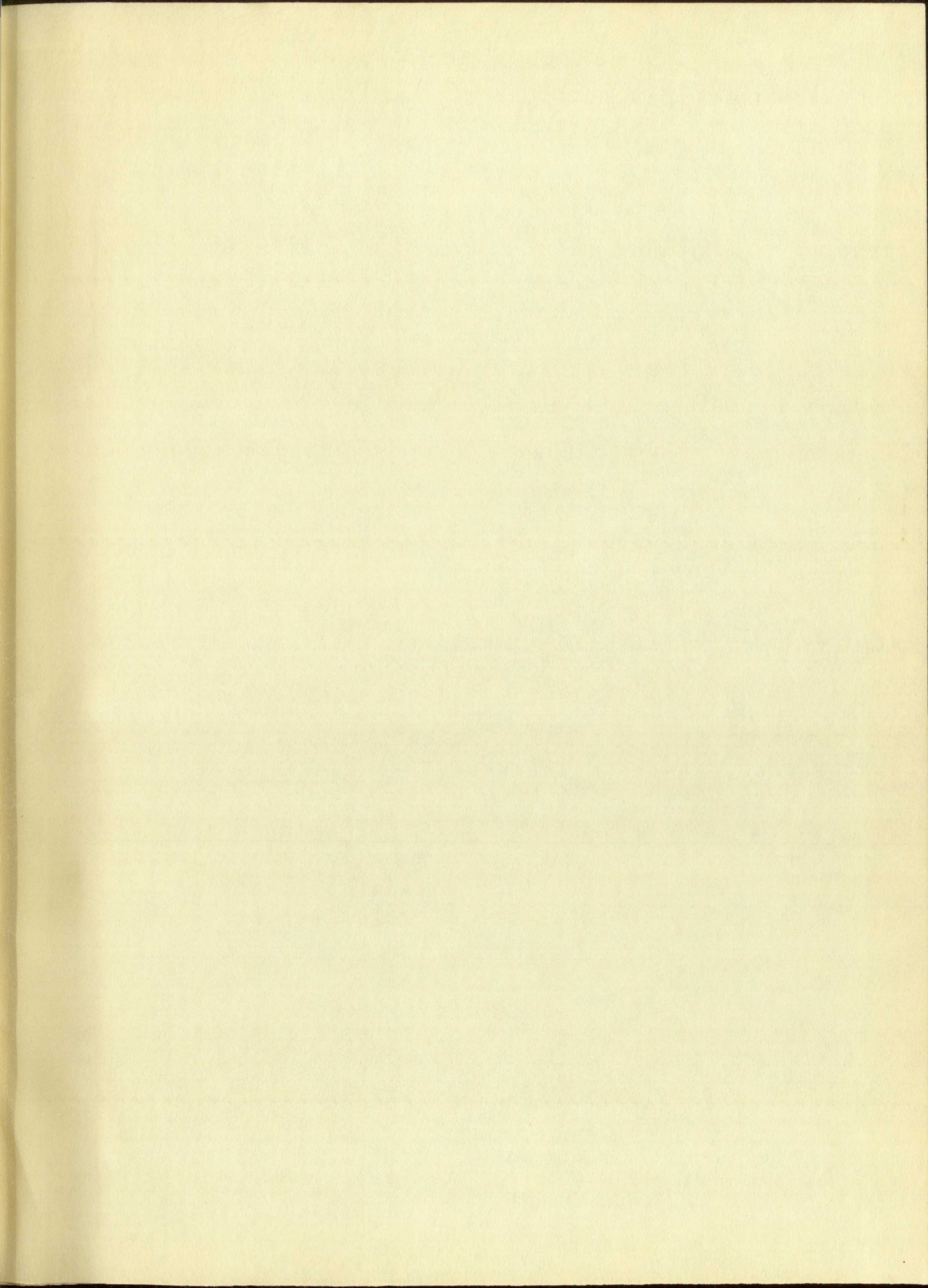
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AN ANALYSIS OF THE EFFECT OF CHANGING
PRICE LEVELS ON FINANCIAL STATEMENTS



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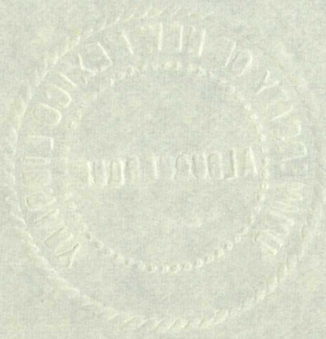
Robert Donald Clyde

A Thesis

Submitted in Partial Fulfillment of the
Requirements for the Degree of
Master of Business Administration

The University of New Mexico

1958



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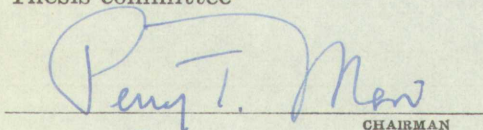
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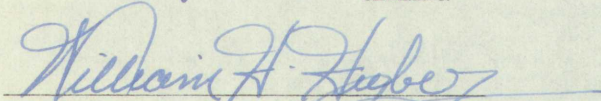
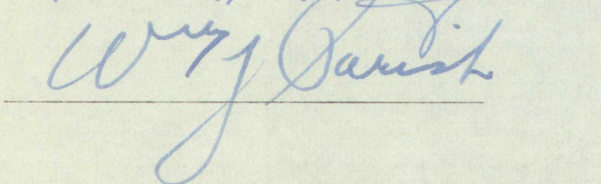

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AN ANALYSIS OF THE EFFECTS OF THE
CHANGING PRICE LEVEL ON FINANCIAL STATEMENTS

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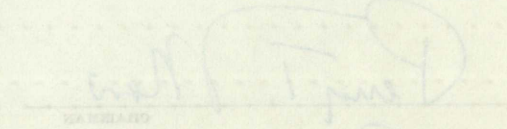
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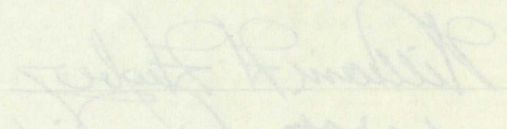
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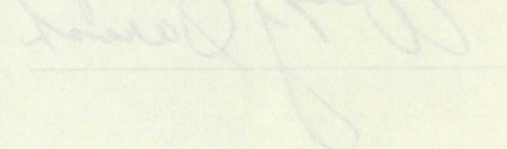
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"If a surgeon practiced blood-letting today as a cure for an infection, the public and the medical profession would be aroused at the failure to use modern methods. Yet, this same public, and the accounting profession generally, permit business profits to be measured without consideration of current economic facts--just because it has always been done that way in the past."

J. W. March

235273

121. A number of principles have been established

as a result of the work of the various committees

concerning the various aspects of the problem

and the various methods of dealing with it

and the various methods of dealing with it

and the various methods of dealing with it

and the various methods of dealing with it

and the various methods of dealing with it

122. It is

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CHAPTER I

PROBLEMS ARISING FROM CHANGING PRICES

When prices change significantly, conventional accounting reports tend to become inaccurate and misleading. Those who use the reports are likely to be misled. Adjustments for price changes cannot readily be made by the reader of financial statements because of the limited information available to him.

Inflation. One of the major problems of accounting, clearly evidenced in the last decade, is the preparation of useful reports when prices change. The problem is, of course, a part of the larger one of unstable price levels in general. Economists and politicians have faced this problem for centuries, and have often classified price changes into cyclical and secular movements. Such a dichotomy has been found to be misleading.¹

An examination of the statistics dealing with price changes prior to World War I indicates price changes have been large in amount, and varied in directions. The Consumer Price Index remained relatively stable during the period 1913-1915 but rose sharply during the war years and the subsequent two years. In 1921 the

¹J. A. Estey, Business Cycles (New York: Prentice-Hall, Inc., 1941), Chapter I.

THE UNITED STATES OF AMERICA

When history is written, the United States will be remembered as a nation that has always stood for freedom and justice. The people of the United States have always been proud of their country and its values. They have always been proud of their country and its values.

It is the duty of every citizen to support their country and its values. They should always be proud of their country and its values. They should always be proud of their country and its values.

The United States is a great country. It is a country that has always stood for freedom and justice. The people of the United States have always been proud of their country and its values.

THE UNITED STATES OF AMERICA

Index decreased approximately nine points and then remained relatively stable through the 1920's. Prices dropped severely in the 1930's and remained at a low level until the inflationary impact of World War II affected the price indices. From 1940 to 1948 prices were on an upward trend. A slight decrease occurred in 1949, but then the upward trend continued through 1956.² Using the past as a guide, it is reasonable to expect similar change in the future.

Accountants in this country have been unwilling or unable to deal adequately with this situation to date. Therefore, the problem of this thesis is to analyze the effects of a rising price level on financial statements by:

1. Reviewing the problems arising from changing prices,
2. Scrutinizing present accounting theory applicable to presentation of financial data,
3. Studying proposed theories of price level modifications of financial statements, and
4. Proposing procedures that will enable accountants to prepare financial statements that will be more significant, comparable, and accurate during periods of changing prices.

Because of the unprecedented inflation of the past decade and the projected long-term upward trend in prices, the emphasis in this study has been placed on the elimination of illusory gains from financial statements. However, this does not minimize the importance of adjusting financial statements when prices turn downward. One

² Appendix, Table I.

Index decreased approximately 100 points and this remained relatively stable through the 1930's. These figures, however, in the 1940's remained at a low level until the mid-1940's, after which they began to rise. The price index, from 1940 to 1945, rose to an upward trend. A slight decrease occurred in 1947, but since the upward trend continued through 1948, during the year as a whole, it is reasonable to expect similar change in the future.

Assessments in this country have been made in an attempt to deal adequately with this situation. However, the problem of this study is to analyze the effects of a rising price level on financial statements by:

1. Reviewing the problems arising from changing prices;
2. Determining the effect of changing prices on the presentation of financial data;
3. Reviewing proposed methods of price level adjustment of financial statements; and
4. Applying these methods to the financial statements of a company to determine the effect of price level changes on the presentation of financial data.

Because of the unprecedented inflation of the past decade and the projected long-term upward trend in prices, the problem in this study has been placed on the financial statements of a company. However, this does not eliminate the importance of adjusting financial statements when prices rise. One

reason why this problem has not been previously solved is that the interest subsides when prices turn downward.³

Non-accounting problems. The effects of inflation upon individuals and businesses vary because some prices move more rapidly than others. People with fixed or lagging incomes, such as pensions or annuities, are hurt during inflation. Likewise the creditor, who receives back a certain number of dollars and finds them less valuable than those he lent, is also hurt. The debtor, however, finds it steadily easier to meet his payments. The fate of the wage earner varies depending on his particular position. The real income of some have increased, whereas others have found their real income to be lower.

Those receiving dividends are in a somewhat better position in the upswing, but often find the rate of increase in dividends to be less than the rate of increase in prices.⁴ The aforementioned problems are directly associated with the instability of the monetary unit.⁵ Such problems are difficult to isolate because monetary policy in recent years has been directed to a number of social or

³Thomas H. Sanders, "Inflation and Accounting," Harvard Business Review (May-June, 1952), p. 50.

⁴W. A. Paton, "How Have Stockholders Been Faring?," Michigan Business Review, (May, 1952), pp. 37-42.

⁵Percival F. Brundage, "Price Level Changes--Effect on Income," Journal of Accountancy (February, 1952), p. 190.

reason why this problem has not been previously given the same
interest subsidies when prices were low.

Non-accounting problems. The effects of inflation

Individuals and businesses very become more price sensitive
rapidly than others. People with fixed or lagging incomes, such as
pensioners or annuitants, are hurt during inflation. Likewise the
creditor, who receives back a certain number of dollars and has
them less valuable than those he lent, is also hurt. The debtor,
however, finds it steadily easier to meet his obligations. The
of the wage earner varies depending on his particular position.
The real income of some have increased, whereas others have found
their real income to be lower.

Those receiving dividends are in a somewhat better position
in the upswing, but often find the rate of increase in dividends to
be less than the rate of increase in prices. The government's
problems are directly associated with the instability of the dollar.
Such problems are difficult to handle because monetary
policy in recent years has been directed to a matter of credit

¹Thomas E. Sanders, "Inflation and Government Budgets," Business Review (May-June, 1952), p. 20.

²W. A. Foster, "How Have Our Countries Been Hurt?", Business Review (May, 1952), pp. 27-28.

³Perceval E. Brundage, "The Real Level of Income," Journal of Accounting (February, 1952), p. 120.

political objectives, such as low interest rates on government debt and maintenance of full employment. Stability of the monetary unit has not been a major purpose of national policy.⁶ "One reason why money does unpleasant things to us is that our minds become obsessed by monetary illusions. Through long practice and custom we have come to believe that money provides an invariable measure of value."⁷

Various shortcomings of conventional accounting reports.

Three objections to accounting practices were made by H. W. Sweeney in his book Stabilized Accounting.⁸ Although this book was published in 1936, Sweeney's objections broadly summarize today's shortcomings of accounting reports. The objections are:

1. The probable objective of business is to obtain consumption goods, not merely dollars.

2. Measurements are not made with a constant unit, since the dollar fluctuates in value,

3. Reports do not reveal gains and losses arising solely from changes in the value of the dollar.

These objections center around the fact that the dollar of today is different than the dollar of past years. Mr. Spacek, managing partner of a national accounting firm, states: "Under the

⁶Ibid., p. 193.

⁷Ibid., p. 194: Direct quotation from Wesley Mitchell.

⁸H. W. Sweeney, Stabilized Accounting (New York: Harper Brothers, 1936), Chapter I.

political objectives, such as the maintenance of the dollar's value, the debt and maintenance of full employment, stability of the monetary unit has not been a major purpose of monetary policy. Why money does not increase in value is due to the fact that it is not increased by monetary authorities, through their power to create money. We have gone to California that money is not increased in value of value."

Various objections to monetary policy
 Three objections to monetary policy were made by the monetary unit in his book Stabilized Economy. Although the monetary unit in 1930, Sherris's objections to monetary policy are as follows of accounting reports. The objections are:

1. The probable effect of monetary policy is to create confusion in the minds of the public, not monetary policy.
 2. Monetary policy is not a sound basis for a sound economy since the dollar is not a sound basis.
 3. Reports do not reveal what is really going on in the dollar.
- These objections are based on the fact that the dollar is today is different than the dollar of 1930. The dollar is no longer a unit of account, but a unit of exchange.

6 ibid., p. 133.

7 ibid., p. 133. Stabilized Economy, Chapter 1.

8 H. W. Sherris, Stabilized Economy (New York: Harper Brothers, 1930), Chapter 1.

accounting principles accepted today there is no way of accounting truthfully for what every normal person knows is fundamental about inflation--that today's dollar is substantially different from a 1930 or a 1940 dollar."⁹ The problem is analagous to the one accountants face in preparation of statements of foreign subsidiaries. They would not think of combining francs and dollars, yet in domestic reports they do combine dollars of quite different values. This practice makes the statements less meaningful, and valid comparisons over a period of time become impossible.

Changes in accounting reports. Little has been done in the United States in practice to modify conventional financial statements. There is frequent reference to the problem by corporation presidents in annual reports when they are faced with the task of explaining misleading financial statements--especially low dividends in view of record profits.¹⁰ The reluctance to change conventional accounting reports is related to the argument advanced by many that

⁹Leonard Spacek, "The Elusive Truth of Business Profit," The Arthur Andersen Chronicle (December, 1956), p. 28.

¹⁰ An excellent example of the concern many corporation presidents have over the misleading financial statements they present to the stockholders is the Yearly Report to Stockholders--1956, of The Reece Corporation. Mr. F. A. Reece compares reported profits to profits adjusted for the increasing price level. Graphic presentation is included illustrating the impact of inflation on profits and dividends.

accounting principles applied to the use of assets
initially for which every asset is valued at
initial cost--that is, the dollar value of the asset
1930 or a 1930 dollar. The practice is to value assets
at the time of acquisition of the asset or at the time of
They would not think of recording them at 1930, but at the
reports they do compile reflect the value of the assets.
practice makes the statements more meaningful and useful
over a period of time because important.

Changes in accounting practices.

United States in practice is really somewhat of a
method. There is a great deal of change in the
practice in general reports with which the assets are

1930-1931

explaining; that is, the assets are

in view of record practice. In the United States
accounting reports are related to the assets and

1930-1931

2. General reports. The general reports are
The Assets and Liabilities. (General, 1930, p. 10.)

10

An excellent example of the general reports is
found in the general reports. The general reports are
the stockholders in the form of a statement of
General Corporation, 1930, p. 10. The general reports are
practices adjusted to the general reports. The general reports
also in general reports and general reports.

the changes in prices have been too small to warrant adjustment.¹¹ This point of view implies that a sufficient change in prices would render the monetary measure of income of little use. In other words, given major price changes such as those in some foreign countries, the historical cost basis of accounting would have to be abandoned. This is exactly what happened in many European countries following World Wars I and II. These countries experienced inflation much greater than ours.

Kristensson found that the wholesale price index in Sweden moved from 100 in 1913 to 340 in 1918.¹² They partially corrected for this by adjusting the depreciation from the cost basis to recognize the inflated current price level.

Sweeney noticed in his study the inflation in Germany was so staggering that a method of deflation was used, based on the gold mark of an earlier base period.¹³

The experiences of France between 1937 and 1948, when prices rose ten times, are interesting. Kennedy reports that when the

¹¹ American Accounting Association, "Accounting Concepts and Standards Underlying Corporation Financial Statements, 1948 Revision," Accounting Review, (October, 1948), pp. 39-44.

¹² R. Kristensson, "The Consequences of Errors in Accounting Due to Inflation--1914-1918," Economic History (February, 1940), pp. 371-83.

¹³ H. W. Sweeney, "How Inflation Affects Balance Sheets," Accounting Review, (December, 1934), pp. 104-16.

the changes in prices have been so small as to be almost negligible.

This point of view implies that a small change in prices

would render the monetary system of balance of payments.

Other points, given before, are not so clear as they seem.

foreign countries, the situation, and the state of accounting would

have to be abandoned. This is a point which is not in any

European countries following from the fact that the countries

experienced inflation which was not very high.

It is interesting to note that the situation in the

moved from 1950 to 1955, and the situation in 1955

for this by adjusting the figures for the year 1955 to

recognize the inflation which has taken place.

Switzerland is not in this group, the situation in 1955

so as to give a more realistic picture of the situation in 1955.

gold mark of an earlier time.

The experience of France between 1950 and 1955, which is

more than 100%, is interesting, and it is not clear

11. American Accounting System, 1950, 1955, 1960, 1965, 1970, 1975, 1980, 1985, 1990, 1995, 2000, 2005, 2010, 2015, 2020, 2025, 2030, 2035, 2040, 2045, 2050, 2055, 2060, 2065, 2070, 2075, 2080, 2085, 2090, 2095, 2100, 2105, 2110, 2115, 2120, 2125, 2130, 2135, 2140, 2145, 2150, 2155, 2160, 2165, 2170, 2175, 2180, 2185, 2190, 2195, 2200, 2205, 2210, 2215, 2220, 2225, 2230, 2235, 2240, 2245, 2250, 2255, 2260, 2265, 2270, 2275, 2280, 2285, 2290, 2295, 2300, 2305, 2310, 2315, 2320, 2325, 2330, 2335, 2340, 2345, 2350, 2355, 2360, 2365, 2370, 2375, 2380, 2385, 2390, 2395, 2400, 2405, 2410, 2415, 2420, 2425, 2430, 2435, 2440, 2445, 2450, 2455, 2460, 2465, 2470, 2475, 2480, 2485, 2490, 2495, 2500, 2505, 2510, 2515, 2520, 2525, 2530, 2535, 2540, 2545, 2550, 2555, 2560, 2565, 2570, 2575, 2580, 2585, 2590, 2595, 2600, 2605, 2610, 2615, 2620, 2625, 2630, 2635, 2640, 2645, 2650, 2655, 2660, 2665, 2670, 2675, 2680, 2685, 2690, 2695, 2700, 2705, 2710, 2715, 2720, 2725, 2730, 2735, 2740, 2745, 2750, 2755, 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8570, 8575, 8580, 8585, 8590, 8595, 8600, 8605, 8610, 8615, 8620, 8625, 8630, 8635, 8640, 8645, 8650, 8655, 8660, 8665, 8670, 8675, 8680, 8685, 8690, 8695, 8700, 8705, 8710, 8715, 8720, 8725, 8730, 8735, 8740, 8745, 8750, 8755, 8760, 8765, 8770, 8775, 8780, 8785, 8790, 8795, 8800, 8805, 8810, 8815, 8820, 8825, 8830, 8835, 8840, 8845, 8850, 8855, 8860, 8865, 8870, 8875, 8880, 8885, 8890, 8895, 8900, 8905, 8910, 8915, 8920, 8925, 8930, 8935, 8940, 8945, 8950, 8955, 8960, 8965, 8970, 8975, 8980, 8985, 8990, 8995, 9000, 9005, 9010, 9015, 9020, 9025, 9030, 9035, 9040, 9045, 9050, 9055, 9060, 9065, 9070, 9075, 9080, 9085, 9090, 9095, 9100, 9105, 9110, 9115, 9120, 9125, 9130, 9135, 9140, 9145, 9150, 9155, 9160, 9165, 9170, 9175, 9180, 9185, 9190, 9195, 9200, 9205, 9210, 9215, 9220, 9225, 9230, 9235, 9240, 9245, 9250, 9255, 9260, 9265, 9270, 9275, 9280, 9285, 9290, 9295, 9300, 9305, 9310, 9315, 9320, 9325, 9330, 9335, 9340, 9345, 9350, 9355, 9360, 9365, 9370, 9375, 9380, 9385, 9390, 9395, 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10200, 10205, 10210, 10215, 10220, 10225, 10230, 10235, 10240, 10245, 10250, 10255, 10260, 10265, 10270, 10275, 10280, 10285, 10290, 10295, 10300, 10305, 10310, 10315, 10320, 10325, 10330, 10335, 10340, 10345, 10350, 10355, 10360, 10365, 10370, 10375, 10380, 10385, 10390, 10395, 10400, 10405, 10410, 10415, 10420, 10425, 10430, 10435, 10440, 10445, 10450, 10455, 10460, 10465, 10470, 10475, 10480, 10485, 10490, 10495, 10500, 10505, 10510, 10515, 10520, 10525, 10530, 10535, 10540, 10545, 10550, 10555, 10560, 10565, 10570, 10575, 10580, 10585, 10590, 10595, 10600, 10605, 10610, 10615, 10620, 10625, 10630, 10635, 10640, 10645, 10650, 10655, 10660, 10665, 10670, 10675, 10680, 10685, 10690, 10695, 10700, 10705, 10710, 10715, 10720, 10725, 10730, 10735, 10740, 10745, 10750, 10755, 10760, 10765, 10770, 10775, 10780, 10785, 10790, 10795, 10800, 10805, 10810, 10815, 10820, 10825, 10830, 10835, 10840, 10845, 10850, 10855, 10860, 10865, 10870, 10875, 10880, 10885, 10890, 10895, 10900, 10905, 10910, 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government passed legislation allowing higher depreciation rates, "the revised statements came as a shock to owners and management who had been paying taxes and dividends 'out of capital'." He further states that although France's attempt to legislate a solution was only partially successful, it was desirable.¹⁴

The replacement cost theory is accepted in Holland and Belgium as a direct result of extreme inflation.¹⁵

Consideration of objections to changes. The objections to changes in financial statements must be many and powerful, since little has been accomplished in spite of a recognized inflation and the experience of foreign countries. Objectors to change are found in all fields of business in addition to the accounting field, since a change in reporting really involves recognizing a different concept of income. A survey conducted a few years ago of security analysts revealed a majority of the analysts to be of this opinion: "Since the analysts and nearly everyone else still think in terms of dollars (i.e., today's dollar--a dollar is a dollar) the attempt to adjust the dollar via index numbers or some pseudo-replacement values merely offers a fuzzy concept instead of a

¹⁴ John Kennedy, "Revaluation of Fixed Assets in France," The Accountant, (December 11, 1948), pp. 469-70.

¹⁵ Bernard H. Levy, "Accounting Practices in Belgium--Its Implication for Americans," Journal of Accountancy (April, 1949), pp. 320-3.

workable, significant concept.¹⁶

The American Institute of Accountants maintains a position of not changing conventional accounting reports. The Institute recommends that information to stockholders, employees, and the general public regarding the changing price level be given in supplementary financial schedules, explanations or footnotes. The Institute believes the immediate problem can and should be met by financial management. However, the opinion is qualified by stating: "Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries."¹⁷ The question immediately arises in reply to this statement as to when dollar costs lose their practical significance.

An objection to changes in financial reporting that is commonly made goes beyond the statements of corporations to the small businessman. Accounts are kept; profits are computed, and policy decisions are made by several hundred thousand individual businessmen, their bookkeepers and their clerks. Most of them

¹⁶ Charles T. Horngren, "Security Analysts and the Price Level," Accounting Review (October, 1955), pp. 575-581. (A study based on a survey of fifty-one security analysts in New York and Chicago.)

¹⁷ American Institute of Accountants, Restatement and Revision of Accounting Research Bulletins. (New York: American Institute of Accountants, 1953), Chapter IX, p. 69.

workable, significant results.

The American Institute of Certified Public Accountants

of not changing conventional accounting practices.

Recommendations have been made to the Institute.

General public regarding the accounting profession.

Supplementary financial statements, reports of the Institute.

The Institute believes the accounting profession has a duty to

not by financial statements, but by the quality of the

by existing, financial statements, and the quality of the

dollar costs of the financial statements, and the quality of the

necessary to create a financial statement, and the quality of the

currency, as has been done in the past, and the quality of the

financially sound, and the quality of the financial statement, and the quality of the

costs of the financial statement, and the quality of the financial statement, and the quality of the

In addition to the above, the Institute has also

examined the quality of the financial statement, and the quality of the financial statement, and the quality of the

small businesses, and the quality of the financial statement, and the quality of the financial statement, and the quality of the

policy decisions, and the quality of the financial statement, and the quality of the financial statement, and the quality of the

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Accountants, 1970, Chapter 1, Section 1.

would have great difficulty in understanding and applying the principles of measuring cost expirations in terms of hypothetical purchasing power. The problems in measurement and judgment they now face would be magnified many times over.¹⁸ However, difficulty with these problems should not prevent the consideration of adjusted reports that might be more useful than the conventional type reports.

Reasons why adjusted reports might be more useful. Financial statements that report the results of "real" profits, rather than monetary profits, would probably serve management, investors, labor, government agencies and the entire economy in a more accurate and informative way.

Management recognizes the problem of price level changes in regard to financial statements. On several occasions, management has attempted to publish financial statements showing real-economic profits. Their efforts were blocked by the Securities and Exchange Commission supported by a majority of the practicing accountants.

Many investors have purchased stock in corporations in recent years based on the reported profits. Mr. Spacek questions these investors by asking: "Are Industrial Common Stocks Selling

¹⁸ E. B. Wilcox, "The Case Against Price-Level Adjustments in Income Determination," Journal of Accountancy (December, 1950), pp. 493-505.

on Fictitious Earnings?"¹⁹ He claims the stocks are selling on fictitious earnings and points out the overstatement of reported income, the dissipation of capital through taxes and income, and the probable over-pricing of stock in major industries. The high level of profits reported by conventional accounting practices has exerted an important influence on the pattern of national wage increases and has aided labor demands for public and political support. Current literature is full of data that illustrates the continuing wage increases' spiraling effect on inflation.²⁰

Government agencies have been deeply concerned with the damaging effects of inflation. Perhaps they have not appreciated the direct relationship of misleading financial statements to cyclical fluctuations, or, more definite action would have been taken to modify financial statements published for use by the general public. Charging unrealistic past costs against current revenue overstates profits in periods of rising and high prices, thereby artificially stimulating business expansion and prices. Conversely, in declining and low prices, income has been substantially understated by charging unrealistic past high costs against current low income. Satisfactory business operation is not

¹⁹ Leonard Spacek, "Are Industrial Common Stocks Selling on Fictitious Earnings?" The Arthur Andersen Chronicle, (April, 1956), p. 83.

²⁰ Business Profits--Fact or Fable, op. cit., p. 31.

on Production Expenditures...
Production Expenditures...
income, the distribution of...
the possible over-...
level of profits...
exerted an...
increases and has...
support. Current...
the continuing...
Government...
damaging effects...
the direct...
cyclical...
taken to...
general public...
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reported by conventional financial statements in such periods; incorrect reporting thereby prolongs a depression.²¹

The subsequent chapters will present the problems set forth in this chapter, the necessity for a workable solution, and the impact of financial statements reflecting the economic facts of business operation. Weston's suggestion should be kept in mind: "Relevant approximation is to be preferred to obsolete precision."²²

²¹ Rufus Wixon, et. al., Accountants' Handbook (New York: The Ronald Press, 1956), pp. 18-27.

²² J. Fred Weston, Book Review of "Changing Concepts of Business Income," American Economic Review (September, 1952), p. 664.

CHAPTER II

BUSINESS INCOME DETERMINATION

Much has been written in regard to the proper determination of business income. Business income is usually thought of as an increase in capital.¹ However, beyond this point of agreement, there is a wide range of disagreement. How should business income be valued? Presently, business income is valued in accordance with generally accepted accounting principles.

Most accounting principles are merely practical conventions. The frequently used phrase "in conformity with generally accepted accounting principles" is vague, broad in scope, and is used emphatically. A search for these principles reveals that there is no list to which we may turn. By reading the publications of the American Institute of Accountants and the American Accounting Association, textbooks, and current periodicals, one becomes aware of fairly uniform underlying concepts. These, however, are subject to varied applications in practice.

Upon analyzing accounting concepts, the fact is evident that the concepts are not "principles" in a sense of fundamental truths.

¹ James L. Dohr, "Limitations on the Usefulness of Price Level Adjustments," Accounting Review (April, 1955), p. 202.

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which has been attributed to the fact that the theory of accounting of business income, business costs, and business expenses is not as yet in a state of finality. However, it is generally agreed that there is a wide range of difference of opinion as to what should be valued. Presently, business income is valued in terms of the with generally accepted accounting principles.

Most accountants agree that the theory of accounting is not yet in a state of finality. The frequently used phrase "in conformity with generally accepted accounting principles" is vague, broad in scope, and is used emphatically. A search for the principles which are to be followed is no list to which we may turn. It is a matter of the political will of the American Institute of Accountants and the American Accounting Association, textbooks, and current publications, and the books of fairly well known authors, such as, "The Theory of Accounting" by J. A. Johnson, "The Theory of Accounting" by J. A. Johnson, and "The Theory of Accounting" by J. A. Johnson. Upon analyzing accountants' theories, we find that the concepts are not "principles" in a sense of fundamental truths.

¹ James A. Johnson, "The Theory of Accounting" (New York: McGraw-Hill, 1927), p. 1.

The basic concepts of accounting may be considered postulates, i.e., necessary assumptions or conditions upon which the structure of accounting is built.² These concepts change very infrequently. Accounting concepts are sound if they pass the final test: "Will the application of the principle produce accounting information that is most likely to lead to correct decisions."³ The conventions of historical cost, cost valuation, the stable monetary unit, and the matching of historical costs and realized revenues, are the ones which concern this study. When prices change, they are the conventions responsible for many of the effects mentioned in Chapter I. These conventions also play a part in the calculation of business income, and are basic in the recovery-of-invested-cost concepts discussed below.

Concepts of business income. Income has been variously defined.⁴ For purposes of this study the concepts of income have been arranged in four groups; two are monetary concepts and two

² Rufus Wixon, et al., Accountants' Handbook (New York: The Ronald Press, 1956), pp. 1-14.

³ W. J. Graham, "The Effect of Changing Price Levels Upon the Determination and Interpretation of Income," Accounting Review (January, 1949), p. 18.

⁴ One common element is present, however, in almost all definitions of income. This is the idea that income is concerned with some measure of goods, services, or valuable property rights coming into existence or possession during a period as additional and available for use without depleting a formerly existing stock of goods or property rights.

are real concepts. These may also be classified as recovery-of-investment concepts or as maintenance-of-earning-power concepts as follows:⁵

1. Maintenance of monetary earning power,
2. Recovery of monetary investment,
3. Maintenance of real earning power, and
4. Recovery of real investment.

The four types are briefly described in the following paragraphs.

1. The first concept is based on the premise that the money value of a business is the sum of its future net earnings discounted to the present, using an approximate rate of interest. Business income is the monetary increase in the value of net assets (allowance being made for additional proprietary investment). Income represents the total amount of money the concern might distribute during a period and maintain the same earning power in dollars. This concept is in harmony with current economic theory.

2. The recovery of monetary investment concept of income coincides with methods generally used by accountants today. Assets are valued at their historical cost (less

⁵ Donald A. Corbin presented these concepts in a doctoral dissertation submitted to the University of California in 1952. Excerpts of the dissertation were published in the Accounting Review (April, 1953), p. 64.

one real concept, investment concept in an investment concept

as follows:

1. Maintenance of investment concept
2. Recovery of investment concept
3. Maintenance of real investment concept
4. Recovery of real investment concept

The four types are defined in the following

paragraphs:

1. The first concept is based on the investment concept

the many types of investment concept in the investment concept

net earnings determined by the investment concept in the investment concept

rate of interest, investment concept in the investment concept

increase in the value of the investment concept in the investment concept

for additional investment concept in the investment concept

the total amount of investment concept in the investment concept

during a period and maintain the investment concept in the investment concept

dollars. This concept is in recovery of investment concept in the investment concept

theory.

2. The recovery of investment concept in the investment concept

income estimation with investment concept in the investment concept

today, assets are valued at investment concept in the investment concept

Donald A. Smith, Investment Concept in the Investment Concept

Investment Concept in the Investment Concept in the Investment Concept

Investment Concept in the Investment Concept in the Investment Concept

Review (April, 1955) p. 10

estimated allocation of cost write-offs), or at net realizable value when this is below historical cost. Two important problems arise under this generally accepted method of accounting; namely, when is revenue realized, and how should asset values be allocated against these revenues? Revenue is usually recognized when a sale or legal accrual of income takes place; it is measured in current monetary terms.⁶ The allocation of asset cost to revenue is not as widely agreed upon as the recognition of revenue. However, it is usually considered as an allocation of cost, not of asset valuation.⁷ Business income represents the total amount of money which could be distributed without impairing the dollar invested in the business.

3. The concept of maintenance of real earning power involves taking into account changes in the value of the dollar. This would be done first by adjusting future receipts and disbursements for future changes in purchasing power (measured in current dollars) before

⁶ Wixon, op. cit., pp. 1-16.

⁷ American Institute of Accountants, "Accounting Research Bulletin #22," Report of Committee on Terminology, (May, 1944), p. 179.

estimated allocation of cost which, on the other hand, is not
realistic value when this is being allocated to
Two important problems arise in this connection:
accepted method of accounting; namely, when is revenue
realized, and how should revenue be allocated
against these revenues? However, it is usually recognized
when a sale or legal transfer of income takes place, it
is measured in current monetary terms. The allocation
of assets costs to revenue is not as clearly defined as
as the recognition of revenue. However, it is usually
considered as an allocation of cost, not of revenue,
value, and, therefore, income recognition for cost
amount of money which would be distributed among
including the dollar invested in the business.
3. The concept of measurement of real earnings, which
involves taking into account changes in the value of the
dollar. This would be done by adjusting the
receipts and disbursements for their constant
purchasing power (measured in constant dollars) before

Wilson, op. cit., pp. 1-10.

1 American Institute of Accountants, "Accounting for
Bulletin #22, Report of Committee on Terminology, (1937),
p. 179.

discounting them to the present. Such a procedure is presently impossible since we cannot forecast the movement of prices. Business income is the amount of money the firm could distribute and still maintain the same earning power in dollars of constant purchasing power.

4. The last concept to be considered attempts to measure asset cost and expirations of cost in terms of their purchasing power. Revenues are determined as in concept number two above. Expenses allocated to these revenues are measured as the amounts necessary to recover the services from the assets which have been used, measured by the same dollars that measure the revenues realized. Business income, therefore, represents the amount of money the firm could distribute without impairing the purchasing power of the dollar invested in the business.

The concept of business income which should determine the accounting conventions (and not vice-versa) "to produce accounting information that is most likely to lead to correct decisions,"⁸ would be that of Recovery of Real Investment. This concept, in other words, provides that instead of returning only the original number of dollars invested, it would return those dollars increased

⁸ Graham, op. cit., p. 18.

by the effect of the rise in price level.

The concept of maintenance of real earning power (listed as number three of the preceding discussion) might become the more correct concept of business income in the future. It will become more correct when sufficient knowledge is obtained to enable one to forecast movements of the price level.

Review of solutions offered to measure business income when prices change.

Earmark, segregate retained earnings. When adjustments are made for the increasing price level in today's financial statements, a common adjustment is an appropriation of retained earnings. This adjustment is a management decision and earmarks a portion of the retained earnings for the replacement of the plant, thus restricting that portion of retained earnings from the payment of dividends. This solution does overcome a shortcoming of conventional accounting because it records in the accounts a provision for replacement of plant. However, income continues to be overstated since "most corporations count the rise in the cost of replacing plant and equipment as profits."⁹

Use parenthetical statements and footnotes. A pioneering

⁹ Sumner H. Slichter, Testimony before the Joint Committee on the Economic Report of the President, (Washington, D. C., December 6, 1948).

by the effect of the rise in price level.

The concept of substitution of real money power (interest as number three of the knowledge) is the second one. Some correct concept of the second nature in the future. It will become more correct when such a time knowledge is required to enable one to forecast movements of the price level.

Review of relations between the money business system

When prices change.

Expenditure, especially expenditure on goods, is not only a

the main for the increasing price level. It is also a

statement, a demand adjustment in an expenditure

retained savings. This adjustment is a response to

and savings a portion of the retained savings in the

replacement of the price, thus retaining the price of

retained savings from the point of view of the price.

solution does involve a substitution of conventional

accounting because it involves in the account a provision

for replacement of the price. However, there continues to

be retained the price of replacement from the time in

the cost of replacement and replacement as follows.

Use of replacement savings and investment in a business

James H. Hirsch, testimony before the Joint Committee on the Economic Report of the President, Washington, D. C., December 1943.

step in recognizing price level changes in financial statements is the use of parenthetical statements or footnotes. Mr. Morrison, partner of Arthur Andersen & Company, states: "Basically, our Firm position is that price level adjustments should be reflected in the accounts and in the financial statements. We recognize, however, that the time for general application for this has not arrived. Therefore, we might suggest to clients who ask our views on this questionnaire¹⁰ that for the present we believe it would be desirable to give the price level effect on income and financial statements in an appropriate footnote."¹¹ This opinion seems to be widely held by the proponents of price level adjustments.

Rely on supplementary comments by company officials.

The president's letter accompanying annual financial statements sometimes discusses the effect of the changing price level. Such letters are often contained in the steel corporations' annual reports.¹²

¹⁰ The questionnaire referred to by Mr. Morrison was prepared by the American Institute of Certified Public Accountants querying presidents of several corporations on the present methods of reporting to their shareholders. The Appendix contains this questionnaire.

¹¹ Mr. Russell Morrison, letter to partners and managers of Arthur Andersen & Company, (August 19, 1957).

¹² Inland Steel Company, Annual Report, 1956, p. 8. United States Steel Corporation, Annual Report, 1956, pp. 25-28.

step in two-stage price level control in financial state-
ments is the use of an adjusted measure of resources.
Mr. Harrison, Director of Economic Research & Planning, stated
"Essentially, but this position is that price level adjust-

ments should be related to the resources and in the
financial statements. In accounting, however, it is not
for resource application for this has not evolved. I believe,

we might suggest to adjust the price level to the
questionnaire¹⁰. But for the present we believe it would be
desirable to give the price level a role in the financial
statements as an adjusted measure of resources.¹¹

opinion seems to be widely held by the members of the
level adjustment.

Help in adjusting resources of company officials.
The President's Council on Economic Affairs, in its report
months sometimes indicated the effect of the price level
level. Such factors are also contained in the level
correction, which is made.¹²

¹⁰ The questionnaire referred to by Mr. Harrison was prepared
by the American Institute of Certified Public Accountants (AICPA)
President of several corporations, the law and accountancy of the
tag to their shareholders. The AICPA contains this questionnaire.

¹¹ Mr. Harrison's report, "Report to the President and Congress on
Arthur Andersen & Company, August 17, 1957.

¹² Internal Steel Company, 1957, p. 10
Steels Steel Corporation, Annual Report, 1957, p. 10

An objection often raised to this type of disclosure is that the laymen should not have to, and most of them could not, evaluate the effect of alternate methods of presenting financial statements.

Adopt Last-in First-out inventory cost method. This method of costing the inventory more nearly matches current costs and revenues in the income statements. The advocates of LIFO¹³ claim it is a hedge against inflation because only "normal income appears on the income statement and speculative profits, caused by the increase in the price level, are eliminated from that report."¹⁴ While LIFO does not entirely eliminate the effects of inflation from income determination, it is a step in the right direction and has been a partial answer to the effect of inflation on financial reporting.

The LIFO method, for example, has its justification for tax and accounting in the fact that it yields a deduction for "cost of goods sold" that approximates the cost of replacing the product sold. It is clear, in a real economic sense, that there is no difference between the amount of capital used up in a particular situation and the amount it

¹³ An abbreviation used by accountants describing the Last-in First-out inventory cost method. The abbreviation is formed by the first letter of each word.

¹⁴ Waino W. Suojanen, "LIFO as a Spur to Inflation--the Recent Experience of Copper," Accounting Review (January, 1957), p. 42.

would take to replace what has been used up.¹⁵

Cost of replacing the product sold is the concept of measurement used in determining the amount of capital used up when the product is sold. This concept is proper since the approximate cost of replacing the capital used can be ascertained at the time the capital is used up. Therefore, there is no need to measure the capital used by the use of a price level index. However, as will be explained in Chapter III, the replacement cost of a long-term asset cannot be logically used as a measure of the capital that is used up. A price level index is more appropriate for long-term assets.

In order for the LIFO method to produce the desired matching of current costs with current revenues, the inventory quantity at year end must not be below the quantity at the beginning of the year. This point is termed the base point. When the inventory quantity does go below the base point it is usually decreased by an over-balance of strong demand. When this happens there is usually an attempt to build inventory to base point to avoid excessive taxes on incorrectly stated profit.¹⁶ When demand for inventory

¹⁵Wendell P. Trumbull, "Price-Level Depreciation and Replacement Cost," Accounting Review (April, 1958), p. 28.

¹⁶Ibid., p. 44.

would take as evidence that the goods were not

Cost of replacing the goods is the correct one

measurement used in the valuation of goods at cost

up when the goods are sold, the amount is the same

the approximate cost of the goods at the time of sale

ascertained at the time the goods are sold or destroyed

there is no need to measure the goods at the time of sale

a price level index, however, as will be explained in

Chapter III, the measurement of the cost of goods

cannot be regarded as a measure of the value of the

is used up. The price level index is a measure of the

long-term average

In order for the price level index to be a measure of the

measuring of current costs, the price level index must be

very similar to the cost index and must be based on the same

the beginning of the year. This is the case with the price

point. The price level index is based on the cost of goods

point is a fairly accurate measure of the cost of goods

measured. When this happens there is usually a steady rise

which inventory is based upon to show the cost of goods

incorrectly stated profits. The price level index is

is
Wendell L. Wendell, "Price Level Index: A Study of Its
Costs, Accounting Methods, and Uses," 1934, p. 11.

to
1934, p. 11.

stockpiling is added to existing consumption requirements during inflation, there is pressure forcing prices upward. Such a policy tends to "store" rather than use a part of the inventory; therefore, the entire economy is hurt from the non-utilization of needed resources.

The LIFO method is usually considered to be desirable in partially eliminating the effect of the rising price level in determination of income. However, it is wise to consider how LIFO can supplement the effects of the rising price level.

LIFO and similar cost-of-goods-sold methods are the only widespread application of price-level accounting now in effect in the United States.

Depreciate on replacement cost. If income be regarded as that which may be withdrawn without reducing capital investment, and capital investment be regarded as physical rather than monetary, it seems logical to conclude that provision for plant replacement should be made by charges to income by basing depreciation on replacement cost.¹⁷

This reasoning was a strong factor in the "Chrysler Formula" and the "Steel Formula" of 1947.

¹⁷ Morton Backer, editor, Handbook of Modern Accounting Theory (New York: Prentice-Hall, Inc., 1955), p. 262. Also, see Chapter III for discussion of "replacement cost."

accepting as valid the existing conventional wisdom, during inflation, there is excessive demand for money. Such a policy tends to "force" money into the hands of the inventory holders, and thus money is not used in the non-utilization of money resources.

The LRU method is usually considered to be a device in practice for adjusting the effect of the trading process level in the determination of money. However, it is not to consider how LRU can influence the effect of the trading price level.

LRU and a similar concept of price-level response are not only widespread applications of price-level response, but in effect in the United States.

Dependence on price-level response. In income response, as that which may be understood without need for any investment, and capital investment is regarded as a rather than money, it seems logical to assume that provision for price response should be made by changes to income by means of depreciation or replacement cost. This reasoning was a strong factor in the "price level" and the "price level" of LRU.

14
Korner, Robert, Money and the American Economy
Theory (New York: Prentice-Hall, Inc., 1952), p. 100.
see Chapter III for discussion of "price-level response."

The Chrysler Corporation decided that the cost of acquiring plant and equipment at the high costs of 1947 was justified only because of exceptional market possibilities for the ensuing few years. Accordingly, Chrysler elected to amortize over a short period the portion of such costs which were in excess of prewar levels.

United States Steel Corporation computed depreciation charges on an estimate of plant replacement cost, which was, of course, considerably higher than historical monetary cost.

E. I. duPont de Nemours & Company was of the opinion in 1947 that amortization of excessive postwar construction costs over a five year period was a proper charge in determining net income for the period and reflected such a charge in its financial statements filed with the Securities and Exchange Commission in the annual Form 10-K report.

However, the Securities and Exchange Commission¹⁸ would not accept the annual Form 10-K reports submitted by the three aforementioned companies which contained financial statements reflecting the departure from the conventional depreciation methods. Earle C. King, Chief Accountant of

¹⁸ See "Role of the Securities and Exchange Commission," in Appendix.

The Chrysler Corporation secured from the first of the
 plant and equipment at the time of 1931 was the
 only source of substantial assets for the
 company for the year 1931. The assets were
 recorded over a short period of time in 1931
 which were in excess of \$100,000.

United States Steel Corporation reported in its
 charges on its assets in 1931. The
 was, of course, a substantial amount of money
 paid.

E. I. du Pont de Nemours & Company in 1931
 1931 that the assets of the company were
 over a five year period was a steady increase in value
 which was known for the period and was not
 change in the financial statements. The assets were
 and Exchange Corporation in the annual 1931 report.
 However, the assets of the company were not
 not record the annual 1931 report. The assets were
 three statements of assets which showed a substantial
 statements which were the assets of the company.
 depreciation in value. The assets were not

the Securities and Exchange Commission in 1947, stated:

"The Securities and Exchange Commission has not approved any departure from presently generally accepted accounting procedures and have no intention of doing so until we are convinced that the minority has a better case than has been presented to date. This appears to be the position of the American Institute of Accountants which I trust will prevail."¹⁹ He added that he finds no basis for reconciling the procedure followed by United States Steel, Chrysler, or duPont.

Each of the aforementioned companies reluctantly filed amended reports to comply with the Securities and Exchange Commission's requirements. Depreciation was computed on the basis of the original cost incurred in all of the amended reports although an accelerated depreciation method of some type was used.²⁰

Internal Revenue Service of the United States Treasury allows deduction for depreciation only on the basis of original cost. The accelerated depreciation provisions of the 1954 Code were not in effect in 1947.²¹ Therefore, the depreciation methods originally used by the aforementioned

¹⁹ Earle C. King, "Current Accounting Problems," An address before Michigan Annual Accounting Conference, Ann Arbor, Michigan, 1948.

²⁰ Backer, op. cit., p. 263.

²¹ See Section 167 of the Internal Revenue Code, 1954.

the Securities and Exchange Commission in 1934, and
 "The Securities and Exchange Commission has not approved
 any departure from generally accepted accounting
 procedures and laws in connection with the preparation of
 financial statements. It is a well known fact that the
 Commission is not a body of accountants, and it is not
 American Institute of Accountants which is responsible
 for the standards of accounting. It is the Commission
 which is responsible for the standards of accounting.
 Each of the registrants is required to submit
 audited reports to comply with the Securities and Exchange
 Commission's requirements. The Commission has adopted as
 the basis of its original cost accounting in all of its
 audited reports, although in some instances the original
 of some type was used.²⁰
 Internal Revenue Service of the United States Treasury
 allows deduction for depreciation only on the basis of
 original cost. The accelerated depreciation provisions of
 the 1921 Code were not in effect in 1934. Therefore, the
 depreciation method originally used by the respondent

¹⁹ See *Earle C. Lind, "Current Accounting Problems,"* in *Report before Michigan Annual Accounting Conference, Ann Arbor, Michigan, 1936.*

²⁰ *See, e.g.,* Rev. Rul. 50, 1935-1 CB 287.

²¹ See Section 167 of the Internal Revenue Act, 1936.

companies were not allowed for tax deductions.

Bulletin #33 issued by the American Institute of Accountants²² supported the Security and Exchange Commission's refusal to accept any departure from generally accepted accounting procedures. "... 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."²³

The "replacement theory" has received much attention and consideration in recent years. Those who oppose the theory always argue that because of the advancement of technology the efficiency of modern equipment far exceeds that of the equipment it is replacing. Therefore, the additional cost to replace the equipment should not be charged against current income.

Conclusion. The aforementioned ways of measuring business income when prices change do not exhaust the solutions that have been offered. These methods are among

²²The American Institute of Accountants changed its name in 1957 to American Institute of Certified Public Accountants.

²³Committee on Accounting Procedure, Restatement and Revision of Accounting Research Bulletins (New York: American Institute of Accountants, 1953), p. 68.

companies were not allowed for the first time.

Further in 1957 issued by the American Institute of

Accountants²² suggested the security and financial

control to ensure the company's financial soundness.

accounting procedures.

changes in accounting procedures should be

undertaken, as these might be a source of

error. It is possible for a company to make the

change at the same time.

The "American Institute of Accountants" has received much attention

and consideration in recent years. Since the passage of

theory argue that because of the importance of

technology the efficiency of modern equipment is needed

that of the equipment is in need of replacement.

additional need to replace the equipment should be

charged against current income.

Conclusion. The statement is one of accounting

business income and other items is not subject to

solutions that have been offered. These are of course

²² The American Institute of Accountants, 1957, p. 10. 1957 to American Institute of Accountants.

²³ Committee on Accounting Procedure, American Institute of Accountants, 1937, p. 10. of Accounting Research Committee (New York: American Institute of Accountants, 1937), p. 10.

the solutions proposed most frequently. Each method provides more useful income statements than if no recognition had been given to the changing price level. However, none of the methods are entirely satisfactory. The subsequent chapters of this thesis will illustrate more emphatically the shortcomings of some of these solutions, other possible solutions, and the urgent need for a true measure of business income.

The Certified Public Accountant's responsibility in certifying reports of business income. The C. P. A. renders his opinion in regard to the financial statements of a business in one brief paragraph. The public relies on this opinion and accepts the method of determination of income to be correct; also, that the resulting figure of net income represents the results of operations for the period covered by the financial statements. Major decisions affecting many people and many phases of the economy are based on the certified financial statement. These decisions are made by business management, stockholders, employee union leaders, government agencies, and many financial institutions. The problem of accounting truthfully for business profits is, therefore, of vital concern to today's, and tomorrow's, economy.²⁴

Every C. P. A.'s opinion, except those for railroads, states

²⁴ Leonard Spacek, "The Elusive Truth of Business Profits," The Arthur Andersen Chronicle. (December, 1956), p. 22.

the solutions proposed most frequently. Each method provides more useful income statements than all no recognition had been given to the changing price level. However, none of the methods are entirely satisfactory. The subsequent chapters of this thesis will illustrate more emphatically the shortcomings of some of these solutions, other possible solutions, and the urgent need for a true measure of business income.

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Every C. P. A.'s opinion, except those for railroads, states

²¹Edward Spence, "The Relative Truth of Business Figures," The Arthur Andersen Chronicle, (December, 1950), p. 22.

that the accompanying statement of income fairly presents the results of operations for the period under review. Income statements cannot fairly present the results of operations without recognizing changing economic conditions--the changing price level. Recognized "generally accepted accounting principles" do not permit statements to show the effect of the changing price level because they are based on the concept of recovery of monetary investment.²⁵ The accounting profession has been guilty of tolerating the misuse of the conventional words "fairly presents."

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Overstatement of business profits in accounting reports is not a theoretical problem. It is far more than a statistical presentation problem.²⁶ The evil roots of inflation might well be buried beneath misleading reports of business income.

²⁵Chapter II.

²⁶Leonard Spacek, "Inflation in Business," An address before the Cincinnati Control of the Controllers Institute of America, (Cincinnati, Ohio, September 10, 1957).

that the accompanying assessment of income fairly presents the results of operations for the period under review. Income statements cannot fairly present the results of operations without recognizing changing economic conditions--the changing price level. Recognized "generally accepted accounting principles" do not enable statements to show the effect of the changing price level because they are based on the concept of recovery of historical investment. The accounting professor has been guilty of following the lead of the conventional words "fairly present."

Overstatement of business profits in accounting reports is not a theoretical problem. It is the same as a statistical presentation problem.²⁰ The only reason statistical data will be buried beneath misleading reports of business income,

²⁵ Chapter II.

²⁰ Leonard Spence, "Inflation in Business," in *Business and the Cincinnati Council of the Four Great Industries of Ohio* (Cincinnati, Ohio, September 12, 1937).

CHAPTER III

TODAY'S FINANCIAL STATEMENTS--USEFUL FACTS OR FICTION

A decade ago a handful of executives of a few leading companies tried to set up warning signs in their corporate accounting to alert shareowners, employees, customers and others to the fact that inflation had distorted conventional bookkeeping. However, the American Institute of Accountants said, "... these are deviations from accepted principles of accounting. The Securities and Exchange Commission agreed with the Institute. Now, experience has proven these enlightened executives to be correct."¹

Today's financial statements. Past costs are useful to management only in the determination of current or probable future costs and are used by good management solely for this purpose.² However, today's financial statements do not recognize the significant difference between past and current costs, but blindly aggregate them and report the resulting "facts" to the users of the financial statements. Sumner H. Slichter said before the Joint

¹M. S. Rukeyser, "Inflation, Accounting," New York Journal American, November 5, 1954.

²Rufus Wixon, et al., Accountants' Handbook (New York: The Ronald Press Company, 1956), pp.

TODAY'S FINANCIAL STATEMENTS

A decade ago a financial statement was a mere listing

companies tried to get up a statement and it was not

accounting to show the company's financial position

to the fact that this statement was not a bookkeeping

However, the American Institute of Accountants said, "The

are variations from accepted methods of accounting.

Securities and Exchange Commission agreed with the Institute.

Now, experience has proven that this financial statement is not

correct."

Today's financial statements have been an attempt to

management only in the determination of current or future financial

costs and are used by the management of the company for this purpose.

However, today's financial statements do not reveal the true financial

financial difference between the company's financial position and the

aggregate time and report the financial statement to the public of the

financial statements. However, financial statements are not

¹ J. A. Hakey, "Financial Statements," *Journal of Accountancy*, November, 1935.

American, November, 1935.

² Ralph Wilson, et al., *Accounting Principles*, 1935, p. 10.
Ronald Press Company, Inc., N.Y.

Committee on the Economic Report of the President, Washington, D. C., December 6, 1948: "During the last three years American corporations have overstated their profits by approximately \$16.4 billion. This is the amount by which reported statements of profits exaggerated the amount of income available to pay dividends, to expand plant, to increase wages, or to reduce prices.

"There are two principal inaccuracies in reports of profits. One arises from the fact that most corporations still insist on counting a rise in the cost of replacing inventories as profits. The other is that most corporations count the rise in the cost of replacing plant and equipment as profits."³

A substantial amount of inventory appreciation, arising from the higher replacement costs which have prevailed, has been included in profit. In only two years of the 1947-1956 period were there any inventory losses, while aggregate net gains reached seventeen billion dollars.⁴ This book gain was taxed as profits resulting in less tangible funds for business. Had the current higher replacement costs been recognized in computing profits, the fictitious book gain would not have caused the factual reduction of tangible funds.

³Sumner H. Slichter, Testimony before the Joint Committee on the Economic Report of the President, Washington, D. C., December 6, 1948.

⁴New England Letter (Boston: The First National Bank of Boston, March, 1957).

Committee on the Economic Report of the President, January 1962.
December 6, 1961. During the last three years, the Commission
have overstated their position by approximately 10 percent. This
is the amount by which reported expenditures of Federal Government
the amount of income available to the Government, to the extent of
to increase wages, or to reduce taxes.

"There are two principal reasons for the overstatement of expenditures.
One arises from the fact that most corporations will include in
counting a rise in the cost of replacing plant and equipment as profit.
The other is that most corporations count the rise in the cost of
replacing plant and equipment as profit."

A substantial amount of investment expenditures, which is
the higher replacement cost with a large overstatement, and has been
in profit. In only two years of the 1950-1960 period was there any
inventory losses, while replacement cost was overestimated. This
dollars. This book says that the total amount of investment expenditures
tangible funds for investment, but the amount of investment expenditures
could be seen reduced in comparison with the total amount of
would not have caused the reported overstatement of investment expenditures.

James M. Callaghan, Secretary of the American
the Economic Report of the President, Washington, D.C., January 1962.
New England Institute of Technology, Boston, January 1962.

Dr. Simon Kuznets comments: "The distorting influence of business accounting practices on any measure of business savings, and hence national income produced, is considerable. Of the various sources of distortion, the changing valuation of inventories appears, for recent years, to have had the largest quantitative effect on business savings and national income produced."⁵ The Last-in First-out method of costing inventory eliminates most inventory appreciation in the computation of profits.

George May, prominent accountant and business consultant, would limit adjustments to reflect realistic income reports to two items. The two items are inventory and plant.⁶ The recording of depreciation on the basis of historical cost rather than current price levels is one of the most serious problems facing us today.⁷ Its importance is due to the fact that it is fixed once the invested dollar is committed to the plant; also, it is variable with the national economy and the value of the dollar.

Price level depreciation. Before proceeding further, the term "price level depreciation" should be clarified. There is a

⁵Henry B. Arthur, "Inventory Profits in the Business Cycle," American Economic Review (March, 1948), p. 33.

⁶Morton Backer, editor, Handbook of Modern Accounting Theory (New York: Prentice-Hall, Inc., 1955), p. 264.

⁷Marvin Johnson, "Misstated Costs and Misleading Profits," The Arthur Andersen Chronicle (December, 1957), p. 16.

Dr. Simon Kuznetz comments: "The historical influence of business accounting practices on any measure of national income, and hence national income trends, is considerable. Various sources of distortion, the changing valuation of inventory appears, for instance, to have had the largest depressive effect on business averages and national income movements. The last-in first-out method of costing inventory, particularly inventory appreciation in the computation of profits, would limit adjustments to reflect changes in the value of items. The two items are inventory and depreciation on the value of fixed capital stock. Depreciation on the value of fixed capital stock is one of the most serious problems facing the price levels in one of the most serious problems facing the price levels is due to the fact that it is fixed once the investment dollar is committed to the plant and, in its relation with the national economy and the value of the dollar, price level depreciation, before producing income, the term "price level depreciation" should be clarified. There is

² Henry S. Arthur, Inventory Profits in the United States (New York: American Economic Review, 1934), p. 53.

³ Norton Becker, editor, Handbook of Business Accounting (New York: Prentice-Hall, Inc., 1937), p. 137.

⁴ Marvin Johnson, Distorted Costs and National Income (The Arthur Anderson Company, 1934).

difference between price level depreciation and replacement cost depreciation.

"Depreciation is the decline in plant capital during a given interval resulting from the expiration of service content or remaining useful life."⁸ Depreciation policy is not relevant to the cost of replacing specific plant assets. It is relevant to the current cost of replacing the capital that was used up during the period. Therefore, depreciation policy is not directly related to the subsequent expenditure for replacing the fully depreciated, worn-out plant asset.

Management has the responsibility to reinvest the funds recouped through the depreciation charge against revenues. If these funds represent the capital that was used up in the period in terms of current purchasing power, then management is charged with the responsibility to invest depreciation funds in such a manner as to avoid further dilution through inflation. They may, or may not, replace the capital asset that has been exhausted of its productive services.

Accompanying FIGURE II of the Appendix is an explanation of the method used by United States Steel Corporation in estimating the deficiency in reported depreciation of \$904 million since 1940.

⁸ Wendell Trumbull, "Price-Level Depreciation and Replacement Cost," Accounting Review (April, 1958), p. 26.

difference between price level depreciation and replacement cost depreciation.

"Depreciation is the decline in value of an asset during a given interval resulting from the exhaustion of service potential or remaining useful life." Depreciation policy is not relevant to the cost of replacing assets; hence, it is irrelevant to the current cost of replacing an asset. Therefore, depreciation policy is irrelevant to the subject of replacement cost depreciation, worn-out plant asset.

Management has the responsibility to replace an asset recovered through the depreciation charge. If these funds represent the capital that was used up in the asset, in terms of current purchasing power, then replacement is appropriate with the responsibility to invest the replacement funds in such a manner as to avoid further dilution through inflation. Thus, or may not, replace the capital asset that has been exhausted in its productive services.

Accordingly, it is the responsibility of management of the method used by United States Steel Corporation in calculating the deficiency in reported depreciation of 1971 million dollars.

⁸ Wendell Trimball, "Price-Level Depreciation and Replacement Cost," Accounting Review (April, 1956), p. 1.

This method is based on the price level depreciation theory and is concerned with recovering the buying power originally expended, not of specifically replacing the worn-out capital asset.

Replacement cost may be correct terminology if the replacement referred to is that of replacing capital used up and not of replacing specific assets.⁹ When one relates replacement to a specific asset the factor of technology becomes important. The new capital asset that replaces the one that was exhausted would probably be technically improved to produce more efficiently. If the depreciation charges on the old asset were related to the purchase price of the new asset a factor of obsolescence would be included; obsolescence should not be misnamed depreciation. Such a misnomer might occur, however, if "replacement cost" were related to replacing specific assets.

Overstated income statements. Capital is the cornerstone of our economic and political way of life. This is a basic fact. Nevertheless, capital is being cannibalized by paying taxes (and to a lesser extent dividends) on overstated profits which thereby weakens our system of free enterprise. For example, assume two companies were identical with the exception that Company A purchased its plant and facilities in 1940 and Company B in 1956. Assume

⁹ Wixon, op. cit., pp. 18-26.

This method is based on the entire level depreciation theory and is concerned with recovering the buying power originally expended, not of specifically replacing the worn-out capital asset. Replacement cost may be correct terminology in the present context, but it is not of technical depreciation theory and is not referred to as such. It is one method of replacement to a specific asset the factor of technology becomes important. The new capital asset that replaces the old one has enhanced value, probably be technically improved, to produce more efficiently. The depreciation charge on the old asset was related to the purchase price of the new asset in terms of obsolescence would be included; obsolescence should not be minimum depreciation. When a mismatch might occur, however, in "replacement cost" some relation to replacing specific assets.

Overstated Depreciation. Capital is the consumption of our economic and political way of life. It is a social fact. Nevertheless, capital is being accumulated by a few people and to a lesser extent distributed on a wide basis which tends to weaken our system of free enterprise. The surplus, because the companies were identical with the exception of the amount of the plant and facilities in 1930 and 1935 and 1940.

further that income before deduction for depreciation was the same for both companies and that the price level in 1956 was twice that of 1940.

	<u>Company A</u>	<u>Company B</u>
Income before deduction for depreciation	\$ 100,000	\$ 100,000
Less: Depreciation charges based on historical cost	<u>10,000</u>	<u>20,000</u>
Net income before taxes	\$ 90,000	\$ 80,000
Corporate federal income tax at 1956 rates	41,300	36,100
Net income after taxes	48,700	43,900
Reservation of income necessary to maintain capital originally invested	<u>10,000</u>	<u>None</u>
Available to stockholders	<u>\$ 38,700</u>	<u>\$ 43,900</u>

The difference of \$5,200 in the amount available to stockholders between the two companies is explained by the taxation of that portion of income which represents a recovery of the higher cost of capital assets, or in other words a tax on capital. Management of Company A would recognize that the allowed depreciation charges were not adequate to maintain the purchasing power of the dollars originally invested in depreciable assets. Therefore, a reservation of income is necessary to maintain the capital originally invested.

further that income before deduction for depreciation and the same
for both companies and that the price-level in 1950 was twice that
of 1940.

Company A	Company B	Income before deduction for depreciation
\$ 100,000	\$ 100,000	Less: Depreciation expense based on historical cost
20,000	20,000	Net income before taxes
\$ 80,000	\$ 80,000	Corporate Federal income tax at 1950 rates
16,000	16,000	Net income after taxes
\$ 64,000	\$ 64,000	Reservation of income necessary to maintain capital structure
12,800	12,800	Invested
51,200	51,200	Available for stockholders

The difference of \$16,000 in the second column is the difference
between the two companies in the amount of the reservation of this
portion of income which represents a transfer of the value of the
of capital assets, or in other words a transfer of the value of the
of Company A would recognize that the right of reservation should
were not adequate to maintain the value of the assets of the company
originally invested in the assets of Company A, a reservation
of income is necessary to maintain the value of the assets of Company A.

Overstated income is a problem of reality and not merely a theoretical or technical problem. The aforementioned areas of past costs being reported are the primary causes of overstated income. In addition to the attack on capital, today's financial statements increase the amplitude of economic cyclical activity.

Overstated income is a boost to inflation. During periods of rising prices past costs overstate income and add to the demands for higher wages, inflated stock prices, and over expansion.¹⁰ The past decade is an excellent example of such a period and illustrates the combination of overstated reports of income and creeping inflation. Recognition and interest in the problem has prevailed before in periods of rising prices. The interest declined when prices ceased to rise although the impact of misleading income statements did not subside.

In periods of declining and low prices understated income is equally as harmful as overstated income is in periods of rising prices. By charging higher past costs against current income, the impression that business in general is suffering losses overshadows the steps toward recovery that management has made. The reported losses are price losses and not management losses.¹¹

¹⁰Willard J. Graham, "The Effect of Changing Price Levels upon the Determination, Reporting, and Interpretation of Income," *Journal of Accountancy* (January, 1949), p. 21.

¹¹Ibid., p. 21.

Overhead... the...
theoretical...
costs being...
In addition to the...
increase the...
Overhead...
of rising prices...
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that, according...
in periods of...
ceased to rise...
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11

Balance sheets and financial condition. Emphasis has been transferred to the income statement in recent years as a managerial tool and an investors' guide. The balance sheet, however, reports the financial condition of a business and the interrelationship of assets, liabilities and stockholders' equity. Also, the balance sheet serves as a report of custodianship from the corporate officers and directors to the stockholders. Transfer of emphasis does not mitigate the need for a factual reporting of financial condition.

Heterogeneous dollars, without conversion, explanation, or qualification, are worse than useless, because they are downright misleading.¹² One learns at an early age that oranges plus apples will not equal oranges. However, 1930 dollars are added to 1950 dollars and reported as equated "dollars". The value of the individual assets in a company's balance sheet are not as significant as their collective value but this is meaningless if different purchasing power dollars are added together.¹³ "About the only part of a single balance sheet that is at all useful is the net working capital sections, and the items in this section tend to be on a current cost basis."¹⁴

¹² Wixon, op. cit., pp. 3-34.

¹³ Percival F. Brundage, "Price Level Changes--Effect on Income," Journal of Accountancy (February, 1952), p. 10.

¹⁴ Graham, op. cit., p. 26.

Significant changes in the price level will affect also the computation of percentages and ratios when some of the figures are in current-year dollars and some in prior-year dollars. When certain percentages and ratios are expressed in current-year dollars (net income to net sales) and others are expressed in prior-year dollars (rate of net income earned on fixed assets), the ratios and percentages become less meaningful.¹⁵

Data hereinbefore presented appears to be quite conclusive that today's financial statements are not useful facts. Why, then, have the traditional financial statements prepared in accordance with generally accepted accounting principles, based on historical cost, prevailed through the years?

Financial statements useful if comparable. In the process of transition from one price level to another, or during a continuous change in the price level, the business world uses the "un-common" dollar for comparison. Meaningful comparisons are not easily obtained from the published financial statements.¹⁶ The wise analyst resorts to analyzing percentage changes, percentage of return on investment, and so forth. However, as was previously cited, such ratios can also be misleading.

¹⁵ Arthur W. Holmes, Elementary Accounting (Homewood, Illinois: Richard D. Irwin, Inc., 1956), p. 655.

¹⁶ Maurice Moonitz, "Adaptations to Price Level Changes," Accounting Review (April, 1948), p. 145.

Significant changes in the level of investment and

composition of percentages and ratios which are

in current-year dollars and have been in effect since 1960.

These percentages and ratios are presented in Exhibit 1.

(Net income is not adjusted for depreciation and amortization.)

Dollars (rate of net income) are in thousands of dollars.

Percentages become less meaningful.

EFFICIENCY

Data hereinafter presented are for the years 1960 through 1964.

FINANCIAL RATIO

PERCENTAGE

With generally accepted accounting principles, the

cost, provided for the year.

FINANCIAL RATIO

of materials from one year to the next.

Continuous change in the ratio of materials to cost.

"an-amount" dollar for a year.

Ratio obtained from the ratio.

Ratio analysis presents a picture of the company's

of return on investment.

Ratio, such ratios can also be used.

15. Arthur W. Brown, Financial Ratios, 1964.

Richard E. Lusk, Financial Ratios, 1964.

16. Financial Ratios, 1964.

Accounting Review (July, 1964).

Progress of a business entity can best be appraised by comparison of a current financial statement with (1) prior years' statements, (2) statements of other companies within the same industry, and (3) with statistics and indices compiled by government agencies. Interrelated factors within a financial statement may also indicate the progress or regression of a company. Several factors should be considered, therefore, when financial statements are analyzed and compared.

1. A current year's financial statement should reflect all dollars on the same basis; a prior year's statement should have been prepared in the same manner in order that reliable comparisons may be made.

2. When comparing two companies unreliable conclusions may be reached because the costs that each company reports have been incurred in various years and, therefore, the units of measurement are different.

3. Statistics and indices compiled by government agencies are used extensively for establishing government fiscal policy and for planning for individual businesses. Statistics are only as reliable as the source data. Since financial statements comprise the source data for many of these statistics, one can logically conclude that the significance of the statistics is partially destroyed by the incomparable source data.

The aforementioned problems could be overcome by the user of the financial statement through extensive research and by adjusting the units of measure to a comparable basis. However, why should accountants present financial data that must be adjusted before they can be used for important business, national, and economic policy determination?¹⁷

¹⁷ Graham, op. cit., p. 24.

The case against price level adjustments. Professor Littleton, a nationally known educator and accounting theorist, firmly believes that the primary function of accounting is to furnish to management data about past transactions expressed in terms of invested cost. "Accounting has an obligation to record and report historical or invested cost, not as a convention nor a tradition, but a service necessity; also, to guard the integrity of its data against internal modification, if those modifications seem likely to undermine objectivity and reviewability."¹⁸ Professor Littleton appears to be of the opinion that price level adjustments would detract from the objective reliability of financial statements prepared on the basis of historical cost. An historical cost basis, through the years, has reduced to a minimum the extent to which the accounts can be affected by the personal opinions of those responsible for them.

Proponents of theories based on historical cost believe the objective of accounting is reasonably clear; namely, that the total charges against all periods combined shall be the total of the initial investment in the property used. Data prepared in this manner shows what was spent to acquire the assets, how much of the cost was absorbed in various periods, when the cost has been fully charged off, and how much remains for the owners in the way of a money return.

¹⁸Wixon, op. cit., pp. 18-23.

One cannot deny that the hard core of a company's financial records is the official corporate accounting records of management's stewardship. This system has always rested upon historical cost records of the transactions which have constituted the company's business. To deny its significance is to deny the significance of all business history. Undoubtedly the integrity of such accounting records is a necessary prerequisite to any work of interpretation.

Beginning in December, 1947, reaffirmed in October, 1948, and maintained through the present date, the American Institute of Accountants "believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level."¹⁹ The Institute concluded "that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar."²⁰ Since the Institute serves as the voice of the accounting profession, these beliefs represented the majority of the practicing profession. However, this majority has been decreasing in recent years.

¹⁹Committee on Accounting Procedure, Restatement and Revision of Accounting Research Bulletins (New York: American Institute of Accountants, 1953), p. 68.

²⁰Ibid.

and cannot deny that the records of the company are
records in the ordinary course of business. The records
show that the company has been in business since
1900. To deny the records is to deny the existence of
all business history. Therefore, the records are
the records of a business which is a part of the
company.

Beginning in 1900, the records of the company
and maintained in the company's books. The records
show that the company has been in business since
1900. The records are a part of the company's
generally accepted records of its business. The
the dollar is a liability of the company. The
that no basis exists in the records of the company
of plant and equipment and a liability of the company
conditions to meet the conditions of the company in the
purchasing power of the dollar. The records show that
the value of the records of the company is a liability
the majority of the records of the company. The records
has been determined to be a liability of the company.

Committee on Accounting, 1900. The records of the
of Accounting, 1900. The records of the company are
Accounting, 1900. The records of the company are

Chapter I referred to a survey of security analysts in regard to price level adjustments. Additional comments made by the analysts are applicable to this section of the thesis. An analyst said: "Price level? Oh, I suppose we plus or minus mentally for it." Another commented that he was against tampering with conventional financial statements by application of price level adjustments.²¹ In lieu of adjusting for price level change, one analyst proposed a fund statement, drafted with full cognizance of its uses and limitations.²² Such a statement might aid considerably in solving some vexing analytical problems that arise when the price level changes. "It might serve much better than price level adjustments to fulfill the needs and wants of those who use the data that accountants are expected to supply in financial reports."²³

Perhaps the basic reasoning behind the existing accounting position concerning adherence to historical cost can be summarized as follows:

1. Cost is definite and objective.

²¹Charles T. Horngren, "Security Analysts and the Price Level," Accounting Review (October, 1955), p. 577.

²²Ibid., p. 581.

²³Ibid., p. 582.

2. The purpose of depreciation is to amortize original cost over a useful life.

3. Hope is maintained that the price level will reverse itself and decline, thereby eliminating the need for adjustment to recognize the change.

4. Adjusted figures might confuse the readers.

5. Historical cost bases are embodied in business custom, law, tax statutes, and Security and Exchange Commission regulations.²⁴

A few brief comments are required in answer to the above statements.

1. Cost is definite and objective, but the measurement thereof is not.

2. Proponents of price level depreciation adjustments go a step further. They say, amortize cost in terms of current dollars over the useful life of the asset.

3. If the price level goes up or down, the problem of price level adjustments remains.

4. Compilation and interpretation of adjusted figures probably would confuse some bookkeepers and some readers, but use of unadjusted figures are only less confusing because the purchasing power problem is ignored.

5. Historical cost is deeply imbedded in all of these categories and is today being promulgated in many institutions of higher learning.

Steps have been taken to reflect current dollars in financial statements without complete departure from the procedures and postulates that have governed accounting for years. The acceptance

²⁴ Thomas H. Sanders, "Inflation and Accounting," Harvard Business Review (May-June, 1952), p. 51.

2. The purpose of business is to make a profit.

3. There is a difference between a business and a profession. A business is a commercial enterprise, while a profession is a service industry.

4. A business is a legal entity that can own property and enter into contracts.

5. A business is a legal entity that can own property and enter into contracts. It is a legal entity that can own property and enter into contracts.

A few brief comments on the business. The business is a legal entity that can own property and enter into contracts.

1. The business is a legal entity that can own property and enter into contracts.

2. The business is a legal entity that can own property and enter into contracts. It is a legal entity that can own property and enter into contracts.

3. The business is a legal entity that can own property and enter into contracts. It is a legal entity that can own property and enter into contracts.

4. The business is a legal entity that can own property and enter into contracts. It is a legal entity that can own property and enter into contracts.

5. The business is a legal entity that can own property and enter into contracts. It is a legal entity that can own property and enter into contracts.

Steps have been taken to make the business a legal entity that can own property and enter into contracts.

Final statements will be made regarding the business. The business is a legal entity that can own property and enter into contracts.

Business Review (May-June 1954)
Thomas H. Brown, Editor

of the LIFO inventory method, a departure from true historical cost, is the most widely known and accepted revision made to reflect current dollars.

Arthur H. Dean, a partner of Sullivan & Cromwell, relates the price level problem to the problems of the 1930's in relation to the gold standard. ". . . our abandonment of the gold standard was then done in the interests of maintaining a stable purchasing power for the dollar as a standard of measure used in legal relationships. True, it caused some confusion, but probably not as great confusion as would have resulted if debtors had to pay gold in a time of world-wide depression."²⁵

When considering a basic modification of accounting procedure one must critically review the practicality of making the change. One must recognize that a modification of recoding and reporting price level adjustments would be costly to the companies initially in implementing the necessary techniques and methods. The writer believes that such costs are justified since the economy as a whole would benefit thereby.

²⁵ Arthur H. Dean, "The Relation of Law and Economics to the Measurement of Income," Accounting Review (July, 1953), p. 330.

of the LEO inventory control system, which is the most widely known and accepted method of current deficits.

Arthur A. Dean, Director of the Federal Reserve Bank of New York, stated that the price level, measured by the Consumer Price Index, is a key factor in the gold standard. The gold standard is a system of monetary control in which the power for the gold is held by the government and is subject to the relations of the gold to the price level. The gold standard is a system of monetary control in which the power for the gold is held by the government and is subject to the relations of the gold to the price level.

When considering a gold standard, the procedure one must follow is to first determine the change. One must determine the change in the price level and report on the level of the price level. The price level is a measure of the value of money and is subject to the relations of the price level to the gold standard. The price level is a measure of the value of money and is subject to the relations of the price level to the gold standard.

CHAPTER IV

WHAT REALLY HAPPENS WHEN PRICES CHANGE

During a period of time there are various financial changes affecting each business unit. Many of these changes take place in terms of current dollars, e.g., sales, purchases, incurring liabilities, payment of dividends, and so forth. However, there are some changes which are not stated in current dollars. For example, depreciable assets or inventories which were purchased in earlier periods may be partially used or sold. Measurement of these expenses in legal, but out-of-date, dollars will be rendered inappropriate when prices have changed during the period. The impact of changing prices may be severe, not only in the area of fixed assets and inventories, but also because of the gains and losses which arise from the holding of monetary assets or liabilities fixed in price.

Conventionally accountants treat all changes as if they occurred in legal dollars which did not change in value. When prices change, accounting should not be limited to merely matching revenues and historical costs. All significant price changes should be revealed so that current and relevant figures will be matched.¹

¹ See statement by the Institute of Cost and Work Accountants, London, England, in the Journal of Accountancy (March, 1953), p. 309.

During a period of this nature the various...
affecting each business...
terms of current dollar...
liabilities, the...
are also...
example, deposits...
in earlier periods...
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The impact of...
of fixed assets...
losses which...
ties fixed in...
Consequently...

occurred in legal...
prices change...
revenue and...
should be...
matched.

I
See statement...
London, England...

Price movements--both individual and average. The effects of price changes are many and may not be accounted for in a simple manner. This is because the prices of all goods or services in the economy do not move uniformly nor in the same direction. The dispersion of specific prices is often great; some move upward while others move downward. This is due to the compound effects of both changes in the money supply and changes in the economic desirability of various goods. However, there is some degree of central tendency in the price movements, and it is possible to estimate an average change in all prices.²

It has often been mentioned that if all prices (including all contracts in money terms) changed proportionately, there would be no effect on anyone. The important point of such comments is that all prices do not change proportionately; therefore, there are gains and losses due to both specific and average price movements.

Distinguishing between types of price changes. There are two distinct problems involved when prices change.³ One is caused by the impact of changes in the relative values of individual assets. The other is caused by the impact of a change in the average price level, which in turn causes the measuring unit to

²Although an index number (or some other measure of change) is only an estimate of the magnitude of the changing price level, it is preferable to less informative, out-of-date, absolute dollars.

³John E. Kane, "Structural Changes and General Changes in the Price Level in Relation to Financial Reporting," Accounting Review (October, 1951), pp. 496-502.

Price movements--both short and long term

of price changes are many and may not be viewed in a simple manner. This is because the price of a good or service in the economy do not move uniformly in the same direction. The dispersion of specific prices is often great, some may rise while others move downward. This is due to the complex nature of both changes in the money supply and changes in the cost of production of various goods and services. There is no simple or central tendency in the price movements and it is possible to estimate an average change in all prices.

It has often been remarked that in all price movements all contracts in money terms change in the same direction. There would be no effect on anyone. The important point of such comments is that all prices do not change proportionately. Some prices are gains and losses due to both specific and average price movements.

Distinguishing between types of price changes. There are two distinct problems involved when prices change. One is caused by the impact of changes in the relative values of individual assets. The other is caused by the impact of a change in the average price level, which in turn causes the same movement in

² Although an index number (an average measure of change) is only an estimate of the magnitude of the changing price level, it is preferable to have information, not only on the average but also

³ John F. Kane, "Statistical Methods and Economic Theory: The Price Level in Relation to Financial Institutions," Statistical Methods (October, 1951), pp. 195-202.

change in size. The failure to recognize or distinguish between the two types of problems seems to have led to a great deal of confusion. It might account for the unsatisfactory solutions which have been proposed so far. When prices change significantly, both types of change should be recognized.

There are several types of income which may be distinguished during periods of changing prices. "Management income" may be defined as the difference between current revenues and current costs.⁴ Another type of income may be termed "price level income" which consists of various gains and losses caused solely by the changes in prices. There are two aspects of price level income. "One is caused by the gains or losses from holding assets which rise more in value than the average rise in prices. The other comes about by holding assets and liabilities whose dollar amounts are legally fixed, while the value of the dollar changes."⁵

When prices of goods and services change some become relatively more valuable than others and a gain is yielded to those holding assets whose values rise more than proportionately. Thus, the money income is limited to the excess of the increase in the value

⁴Willard J. Graham, "Changing Price Levels and the Determination, Reporting, and Interpretation of Income," Accounting Review (January, 1949), pp. 15-26.

⁵Donald A. Corbin, Doctoral Dissertation submitted to the University of California in 1952. Excerpts were published in Accounting Review (April, 1953), p. 65.

of an item over the increase in the general price level. The excess is unrealized income and becomes realized when a sale or exchange is made. The increase in the price of an item which is only proportionate to the increase in the general level of prices is not income; it is only an unrealized monetary gain.

Consider the following:

- | | |
|--|-----------|
| a. An asset costs | \$350,000 |
| b. During the period that the asset was held its price increased | 50% |
| While the average price level increased | 30% |
| c. Its fair market value is now | \$525,000 |

The increase of \$175,000 is not all income, but is partly a capital adjustment:

30% of the increase is a capital adjustment	\$ 52,500
70% of the increase is an unrealized gain	<u>122,500</u>
Monetary gain	<u>\$175,000</u>

The value released when the asset is sold will be \$525,000. The \$52,500 unrealized price level income (which becomes realized when the asset is sold) is not necessarily an amount which the company should then distribute in the form of dividends, since the future replacement cost of the asset may be high.

Sweeney divides the net gain, or loss, from holding fixed dollar assets and liabilities into realized and unrealized portions.

of an item over the increase in the general price level. The change
is unrealized income and income realized in the form of a cash
is made. The increase in the form of an item is also
proportional to the increase in the general price level.
Not income; it is only an unrealized increase.

Consider the following:

- a. An asset owned
- b. During the year the asset was sold at a profit of \$100,000.
The asset was sold at a profit of \$100,000.
- c. The fair value of the asset was \$100,000.

The increase of \$100,000 is the increase in the value of the asset.
adjustment:

10% of the increase is \$10,000.
10% of the increase is \$10,000.
10% of the increase is \$10,000.

The value realized when the asset is sold is \$100,000.
\$100,000 realized when the asset is sold.
the asset is sold) is the increase in the value of the asset.
should then distribute the increase in the value of the asset.

replacement cost of the asset is \$100,000.
Every dollar of the increase in the value of the asset is
dollar assets and liabilities are adjusted to reflect the increase.

The realized portion arises on the fixed dollar assets or liabilities which are disposed of during the period of price change.⁶ For example, an \$800,000 bond issue may have been retired during a period when an index of price level rose from 100 to 150. A gain of \$400,000, measured in terms of current dollars, was realized because the bonds were retired for \$800,000 although this was the equivalent of \$1,200,000 in current dollars.

Unrealized gains, or losses, arise on fixed dollar assets and liabilities which are still held at the end of a period in which the value of the dollar changed. For example, a company may hold a \$50,000 investment in bonds made a year ago when the price level index was 100. If the index stands at 125 at the end of the period, an unrealized loss of \$12,500 has occurred. The investment remains at a cost value of \$50,000 whereas this cost would be the equivalent of \$62,500.

The index number problem. Although the construction of index numbers is outside the normally defined field of accounting, still index numbers are needed by accountants to make adjustments when prices change. Since revaluation is too expensive and time-consuming, index numbers serve as a relatively quick, inexpensive (and probably more accurate) substitute in the revaluation process.⁷

⁶H. W. Sweeney, Stabilized Accounting (New York: Harper Bros., 1936), Chapter I.

⁷Rufus Wixon, et al., Accountants' Handbook (New York: The Ronald Press Company, 1956), pp. 18-19.

The realized portion arises in the period when the bonds are disposed of, which are disposed of during the period in which they were held. For example, an \$800,000 bond issue was sold at a price of 105 during the period when an index of prices for the issue was 100. The realized portion of \$40,000, measured in terms of current dollars, was realized because the bonds were called for \$800,000 during the period of the equivalent of \$1,200,000 in current dollars.

Unrealized gains, on the other hand, arise in the period when the bonds are held and the index rises. For example, if the index rises from 100 to 110 during the period when the bonds are held, the value of the bonds rises from \$800,000 to \$880,000. The unrealized gain of \$80,000, measured in terms of current dollars, is the difference between the value of the bonds at the end of the period, \$880,000, and the value at the beginning of the period, \$800,000. The unrealized gain of \$80,000, measured in terms of current dollars, is the difference between the value of the bonds at the end of the period, \$880,000, and the value at the beginning of the period, \$800,000. The unrealized gain of \$80,000, measured in terms of current dollars, is the difference between the value of the bonds at the end of the period, \$880,000, and the value at the beginning of the period, \$800,000.

The index number method of measuring the change in the value of the bonds is based on the assumption that the index number is a measure of the change in the value of the bonds. Since the index number is a measure of the change in the value of the bonds, the index number method of measuring the change in the value of the bonds is based on the assumption that the index number is a measure of the change in the value of the bonds.

R. W. Sweeney, *Financial Accounting*, 2nd Edition, 1936, Chapter I.

Patricia Wilson, *Financial Accounting*, 2nd Edition, 1936, Chapter I.

There might be a need for indices of specific assets and a general index to permit the measuring unit, the dollar, to be uniform. The latter will be discussed first because it presents special problems when applied to a business.

A general price index. General indices could be chosen which would measure change in the value of the dollar from the point of view of an individual stockholder, the business entity, or the total economy. Although a business firm is an association of individuals, each stockholder has a different standard (and therefore cost) of living. Theoretically real income should be calculated for each person, but of course, this is not feasible in practice.

When considering the value of the dollar to a business, each firm would require a special index, since each has different uses for its dollar. These uses are unknown in part and vary over time. The construction of index numbers would involve estimates and value judgments in weighting. Thus, an objective and verifiable measurement of the changing value of the firm's dollar is impossible. Furthermore, this type of measurement would make comparisons among firms difficult.

Shall the use of a general index of the price level be rejected because it doesn't fit the case of a business as an association of individuals or as an entity? The answer is no.

There might be a need for indices of specific assets and a general index to permit the measuring unit, the dollar, to be uniform. The latter will be discussed first because it presents special problems when applied to a business.

A general price index. General indices could be chosen

which would measure change in the value of the dollar from the point of view of an individual stockholder, the business entity, or the total economy. Although a business firm is an association of individuals, each stockholder has a different viewpoint (and therefore cost) of living. Theoretically real income should be calculated for each person, but of course, this is not feasible in practice.

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Should the use of a general index of the price level be

rejected because it doesn't fit the case of a business as an

association of individuals or as an entity? The answer is no.

Prices have changed too much.⁸ The use of a single objective index will at least provide a rough measure of the change in the value of the dollar in general. When arguments are advanced that index numbers are imperfect measures of change, these merely emphasize the need to remove the imperfections. They do not argue against the use of index numbers.⁹

The remaining alternatives are, therefore, an index which measures prices for the economy as a whole or on an industry. Although not specifically applicable to any person or business entity, such an index will serve as a scale of change against which items and firms may be compared. Fortunately there is a central tendency in price movements;¹⁰ therefore one can be certain that the adjustments are in the proper direction.

Specific indices. Specific indices related to capital goods subject to depreciation are often proposed as being more favorable when adjusting for price level changes. Those who favor a specific index, in lieu of a general price level index, are of the opinion that the replacement of the capital goods being depreciated is the

⁸Table I of the Appendix.

⁹Maurice Moonitz, "Adaptations to Price Level Changes," Accounting Review (April, 1948), p. 140.

¹⁰W. A. Paton, Advanced Accounting (New York: Macmillan Company, 1941), Chapter 33.

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The remaining... measures prices for the... Although not specifically... entity, such an index... which items and... central tendency in... certain that the...

Specific Index... subject to depreciation... when adjusting for... index, in line of a... that the replacement...

Table I of the...

Statistical... Accounting Review... L. A. Brown... Company, 1911, Chapter...

primary purpose of adjusting the depreciation charge. By using a specific index the price level change applicable to the capital asset involved could be more accurately measured. Thus, an asset whose price was moving faster, slower, or opposite to the general price index, could be adjusted for its specific price level change and the adjustment would not be distorted by the average price level change.

The objective of such specific indices would be to approximate the value of the assets based on their earning power. The depreciation and eventual replacement of the assets would be based on such an approximate value. If no established competitive market exists for the item, it may be necessary to use replacement cost for its value. This would be preferable to cost if it is certain that there is a wide variance between the two. As previously noted, actually it is the replacement cost of the services used (not future specific replacement costs) which is relevant for income computation. This means that one must be wary of this method if technology has changed greatly.

Specific indices are available from various sources.¹¹ Foreign governments have often decreed which indices might be used for tax purposes. Also, the United States Government publishes

¹¹ Arthur H. Cole, Measures of Business Changes (Chicago: R. D. Irwin, 1952), p. 62.

primary purpose of adjustment is to bring the value of the property to the level of the market value. The adjustment is made by adding or subtracting certain items from the value of the property. The items which are added or subtracted are those which are not included in the market value. The adjustment is made by adding or subtracting the value of the items from the value of the property. The adjustment is made by adding or subtracting the value of the items from the value of the property.

The object of the adjustment is to bring the value of the property to the level of the market value. The adjustment is made by adding or subtracting certain items from the value of the property. The items which are added or subtracted are those which are not included in the market value. The adjustment is made by adding or subtracting the value of the items from the value of the property. The adjustment is made by adding or subtracting the value of the items from the value of the property.

many indices of both a national and regional character.

General price index favored. The writer favors the use of a general price index when adjusting for price changes in the procedures of income determination. The use of a general price index is consistent with the theory of price-level depreciation, as discussed in Chapter III. Among the factors supporting a general price index are:

1. The cost of replacing specific plant assets, or whether they will be replaced, is irrelevant to the depreciation and price index problem. What is relevant is the current cost of getting new productive agents in the business to take the place of the service benefits that have currently expired.
2. Management has the responsibility for the subsequent expenditure or reinvestment of funds recovered through depreciation. Therefore, the depreciation charge should be the same regardless of whether the funds are spent for replacement of plant and equipment, or for other investments; are funded, or are distributed to the owners. A specific index would be used for the purpose of replacing plant and equipment only.
3. Better comparability of the items comprising the determination of income would be achieved by using a general price index in computing the depreciation charge. Sales, expenses, and inventory costs are expressed in terms of a general price level; therefore, to be consistent and permit better comparability, the depreciation charge should also be reflected in terms of a general price level.
4. Net income of a business should represent purchasing power. Reported net income is analyzed, studied, and forms the bases for decisions of management, labor, stockholders, etc. Therefore, if the reported net income represents general purchasing power, all groups will be better informed since an average purchasing power is reported.

many indices of both a general and regional character.

General price index: Review of the index

General price index was revised in 1962. The revision was based on the procedures of the Bureau of Economic Analysis. The index is a general price index in constant prices of 1962. It is based on the index as discussed in Chapter III. The index is a general price index.

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2. The index is a general price index. It is based on the index as discussed in Chapter III. The index is a general price index.

3. The index is a general price index. It is based on the index as discussed in Chapter III. The index is a general price index.

4. The index is a general price index. It is based on the index as discussed in Chapter III. The index is a general price index.

Most prices have at least doubled in the past two-and-a-half decades. Such a change makes it imperative that dollars of earlier years be adjusted even though an index of the change is not perfect. One can feel confident that this is preferable to using irrelevant historical cost figures.

A new general price index needed. At present there is no index available to serve adequately the purpose previously discussed. The implicit price deflators for gross national product¹² might be suggested, but they are not available monthly, without time-lag, which is a requisite to the problem. Hence, it must be suggested that a new index of the general price level is needed. Frequency of reporting is needed in order to reduce the time-lag. It should be constructed by qualified statisticians if accounting methods are to make general use of the index. Government sponsorship, such as allowing use of the index for tax purposes, would rapidly advance its development.¹³

¹²Gross national product deflators were developed by the National Income Division of the Department of Commerce. The deflator is obtained by taking the quantities of goods and services produced in that year and comparing their total cost in that year with what their cost would have been valued at the prices prevailing in the base year, 1939. Thus, the gross national product deflator of each year is based upon the relation of the cost of goods and services at base-year prices. See A Supplement to the Survey of Current Business, National Income (Washington, D. C.: U. S. Department of Commerce, 1951).

¹³Business Profits--Fact or Fable (Chicago: Business Executives' Research Council of Greater Chicago, and Northwestern University, 1954), p. 253.

Most prices have at least doubled in the past few decades. Such a change makes it impossible to compare years be adjusted even though it is not a simple matter. One can feel confident that the index is a fair representation of historical cost levels.

A new general price index, covering all prices, is now being developed. This index is available to serve as a guide for the general price level. The implicit price deflator, which is a measure of the price level, is suggested, but they are not the same. The index is a composite of many different prices, which is a representative of the general price level. It is not a simple matter to construct a new index of the general price level, but it is a necessary step in the development of reporting is needed in order to make the index a fair representation of the general price level. It is not a simple matter to construct a new index of the general price level, but it is a necessary step in the development of reporting is needed in order to make the index a fair representation of the general price level. It is not a simple matter to construct a new index of the general price level, but it is a necessary step in the development of reporting is needed in order to make the index a fair representation of the general price level.

12. Gross national product (GNP) is a measure of the total value of goods and services produced in a country. It is obtained by taking the sum of the value of all goods and services produced in a country. The value of goods and services produced in a country is obtained by taking the sum of the value of all goods and services produced in a country. The value of goods and services produced in a country is obtained by taking the sum of the value of all goods and services produced in a country. The value of goods and services produced in a country is obtained by taking the sum of the value of all goods and services produced in a country.

13. The National Income and Product Accounts (NIPAs) are a set of accounts that provide a comprehensive picture of the economy. They include the Gross National Product (GNP), the Gross Domestic Product (GDP), and the Personal Income (PI). The NIPAs are used to measure the growth of the economy and to compare the performance of different countries. The NIPAs are used to measure the growth of the economy and to compare the performance of different countries. The NIPAs are used to measure the growth of the economy and to compare the performance of different countries.

Meanwhile an approximation of the general price level can be used in adjusting financial statements. The Consumer Price Index or the Wholesale Price Index are possible choices. Both are available monthly. The Consumer Price Index appears to be better suited as an index for adjusting financial statements. The index of wholesale prices does not measure the general price level or the purchasing power of the dollar since it "excludes some classes of commodities, i.e., real estate, securities, services, etc., which are factors in the 'general price level'."¹⁴ On the other hand, the Consumer Price Index is used in some industries to determine the level of wages. This index also reflects dollars everyone pays and is not affected by price fluctuations of goods which are traded on speculative commodity exchanges.¹⁵

Using index numbers for financial statements. A procedure using index numbers for restating "out-of-date" dollars on financial statements would require the following information:

1. Historical cost, date of acquisition, and estimated life of the asset to be revalued,
2. The level of some appropriate index of prices---
 - a. At the acquisition.
 - b. At the revaluation date.¹⁶

¹⁴Statistical Abstract of the United States, 1957 78th Annual Edition (U. S. Department of Commerce, Washington, D. C.), p. 326.

¹⁵Ibid.

¹⁶Wixon, op. cit., pp. 18-19.

The factors would then be formulated:

$$\text{Historical cost} \times \frac{\text{Index at revaluation date}}{\text{Index at acquisition date}} = \text{Adjusted asset value.}$$

If the asset is depreciable, the depreciation would be computed on the adjusted asset value over the remaining life of the asset.

Income would thereby be charged with a current, realistic depreciation charge. This method was followed in the computations of

Table IX of the Appendix.

The factors would then be calculated:

$$\text{Historical cost} \times \frac{\text{Index of replacement cost} - \text{Index of original cost}}{\text{Index of replacement cost}} = \text{Adjusted cost}$$

If the asset is depreciated, the depreciation should be applied to the adjusted asset value over the remaining life of the asset. Income would thereby be charged with a current, realistic depreciation charge. This method was followed in the calculation of

Table IX of the Appendix.

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CHAPTER V

CASE STUDY OF THE STEEL INDUSTRY AND THE RISING PRICE LEVEL

The steel industry serves as a prime example of the dangers inherent in inflation.¹ This industry has a large investment in long-life fixed assets. Powerful labor unions are present in the industry. An expanding economy demands more and more steel. These three factors have placed the steel industry in a precarious position during the period of the rising price level. The impact of inflation was felt by rising costs and shrinking profit margins, and, at the same time generated the need for a substantial increase in profits to be reinvested by the industry.²

Characteristics of the industry. When one reviews a financial statement of a steel corporation, he readily notices that the relatively large proportion of the corporation's assets are in plant and equipment. Approximately half of the assets of a steel corporation are in long-term fixed assets. The average life of steel facilities and plant is twenty-five years, which means the invested capital will be recovered at the rate of four per cent per

¹Thomas H. Sanders, "Inflation and Accounting," Harvard Business Review (May-June, 1952), p. 50.

²Roger M. Blough, "Inflation as a Way of Life," An address before the National Editorial Association, November 9, 1956 (United States Steel Corporation, 1957), p. 8.

CASE STUDY OF THE STEEL INDUSTRY

The steel industry is a major source of employment in the United States. It is a highly capital-intensive industry, and its production process is highly complex. The industry is characterized by a high degree of concentration, with a few large firms dominating the market. The industry is also characterized by a high degree of technological innovation, with new products and processes being developed continuously.

These three factors have led to a high degree of efficiency in the steel industry. The industry has been able to produce steel at a lower cost than other industries, and it has been able to produce a wide variety of steel products. The industry has also been able to maintain a high level of quality, and it has been able to meet the needs of its customers.

in profile to be released by the industry.

Characteristics of the Steel Industry

One of the most important characteristics of the steel industry is its high degree of concentration. The industry is dominated by a few large firms, which produce the majority of the steel in the United States. This concentration has led to a high degree of efficiency in the industry, as the large firms are able to produce steel at a lower cost than smaller firms. The industry is also characterized by a high degree of technological innovation, with new products and processes being developed continuously.

¹ Thomas A. Sawyer, "The Steel Industry," in *Business Review* (1971), p. 1.

² Sawyer, p. 1. Sawyer also notes that the steel industry is a highly capital-intensive industry, and that it is characterized by a high degree of technological innovation.

year. However, for the past ten years only three-and-one-half per cent has been recovered per annum because of the shrinking value of dollar depreciation. Therefore, to stay-even the steel industry will have to spend millions of dollars per year.³ Expansion is in addition to this requirement. W. A. Walker projects expenditures to stay-even if prices increased at the rate of seven per cent per annum.⁴ He states that costs in the steel industry have been increasing at the rate of seven per cent per annum on the average since 1940; he concludes that to replace a facility after twenty-five years of such increases, it would take \$63.25 for every dollar invested at the beginning of the twenty-five year period.⁵ Although the rate of increase in the preceding example may be questioned, the example illustrates the significant amount of funds required to replace present facilities at today's price level. Regular depreciation (straight-line) would provide only the number of dollars originally expended, not the purchasing power originally expended.⁶

Replacement of present facilities is only part of the problem

³Benjamin F. Fairless, "Inflation, Depreciation, and the Steel Industry," The Commercial and Financial Chronicle (May 31, 1956), p. 30.

⁴Table IV of the Appendix presents these data in tabular form.

⁵W. A. Walker, "Inadequate Depreciation in the Metal Manufacturing Industry," A technical paper (United States Steel Corporation, 1956), p. 5.

⁶Ibid., p. 6.

facing the steel industry. Annual capacity as of June, 1957, was 133 million tons; the industry sees the need for a capacity that can produce 160 million tons by the early 1960's.⁷ The funds for replacement and expansion will come from borrowings and reinvested earnings.

Contained within the Appendix is a graph (FIGURE I) illustrating long-term debt and stockholders' equity in relation to ingot capacity of Inland Steel Company. In order to increase ingot capacity 60 per cent, long-term debt had to be increased 125 per cent and stockholders' equity 175 per cent. "Due primarily to inflation the increase in funds invested in the Company since 1946 has been far more than proportionate to the expansion of our steel capacity."⁸

Borrowing may be justified for profitable expansion, "but borrowing to cover erosion of capital is one of the best ways of going broke that I know of. Most steel companies do not have the capacity to borrow at the present time."⁹

Borrowing is only a temporary solution at best since it must be repaid from future earnings. Russell Peters, Financial Vice-

⁷"How Steel Will Change America," U. S. News & World Report (June 7, 1957), p. 78.

⁸Inland Steel Company, Annual Report, 1956, p. 8.

⁹Fairless, op. cit., p. 31.

Facing the steel industry, which is heavily dependent on exports, the 1955-56 season has been a difficult one. The industry has been unable to produce its full capacity of 10 million tons, and its earnings are correspondingly low.

Continued efforts to increase production and exports are being made. The industry is also working to improve its efficiency and reduce its costs. The government is also providing financial assistance to the industry to help it through this difficult period.

It is expected that the industry will be able to increase its production and exports in the coming months. The government is also planning to provide further financial assistance to the industry to help it through this difficult period.

The steel industry is a vital part of the economy, and it is important that it be able to continue to produce and export its products. The government is committed to supporting the industry in this difficult period.

¹How Steel Will Change Tomorrow, p. 10, The Steel Institute, London, 1955.

²Indian Steel Industry, p. 10, The Steel Institute, London, 1955.

³Release, p. 10, The Steel Institute, London, 1955.

President of Inland Steel Company, states: "Actually, there is only one source of funds for securing the amounts needed to supplement inadequate depreciation allowances and for maintaining present capital intact--constantly higher prices."¹⁰ Peters concludes that the key to the whole problem for steel's money is in the way depreciation is handled for tax and financial statement purposes; many other problems of financial significance would correspondingly be greatly dissipated.¹¹

Although higher prices for steel may provide funds to supplement inadequate depreciation, the basic problem will not be alleviated. Higher prices would add to inflation, thus enlarging the problem. Misstated depreciation allowances not only affect the funds of the companies but also mislead the investor and the wage earner.

As previously mentioned, a factor in the steel industry's problem with rising prices is that of powerful labor unions. Labor often bases its demands for more wages on the profits presented on the published financial statements. However, do these profit figures represent "real" profits? If not, labor's demands are for more than its fair share. Wage increases must be earned by increased production; unearned wage increases serve only to fan the flames of inflation and can ultimately benefit no one. Robert Tyson, Chairman

¹⁰ Russell L. Peters, "Steel's Money Problems," An address before the American Steel Warehouse Association," May 9, 1957 (Inland Steel Company, 1957), p. 14.

¹¹ Ibid., p. 16.

President of Inland Steel Company, Chicago, Ill., said that only one source of supply for the steel industry in the world is the United States. He said that the steel industry is a capital intensive industry and that the key to the steel industry is the availability of capital. He said that the steel industry is a capital intensive industry and that the key to the steel industry is the availability of capital. He said that the steel industry is a capital intensive industry and that the key to the steel industry is the availability of capital.

Although higher prices for steel may result in higher steel prices, the steel industry will not be able to pass on the higher prices to its customers. Higher prices would not be passed on to the customer. The steel industry is a capital intensive industry and the key to the steel industry is the availability of capital. The steel industry is a capital intensive industry and the key to the steel industry is the availability of capital. The steel industry is a capital intensive industry and the key to the steel industry is the availability of capital.

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of the Finance Committee for United States Steel, surmizes: ". . . employment cost inflation (in the steel industry) has averaged seven to eight per cent per annum. With an increase in national productivity averaging two to three per cent per annum, a cost-covering price level increase of some five per cent is the inevitable result."¹²

Thus far in Chapter V the problems confronting the steel industry as a result of the rising price level have been discussed. Further study of these problems will be presented by analyzing production and discussing the areas contained in financial statements most sensitive to price change--inventories and depreciation.

Production of the steel industry. Production of steel is measured in ingot tons. Annual output has increased with the growth of the nation and the economy to the point that in 1957 approximately 110 million tons were produced.¹³ To determine the effect of the rising price level on financial statements of the steel companies, production must be related to significant items reflected on the financial statements. Table VII of the Appendix, "Financial Analysis of the Steel Industry," presents significant factors of production and the financial results of the production

¹²Robert C. Tyson, "Our New Kind of Inflation," An address before the National Industrial Conference Board, May 16, 1957 (United States Steel Corporation, 1957), p. 11.

¹³"How Steel Will Change America," op. cit., p. 81.

of the Finance Committee for United States Steel, Inc.,
employment rose from 1929 to 1932, and in 1932
seven to eight per cent per annum, with an average of about
productivity averaged two to three per cent per annum,
covering price level increase of one per cent in the
inevitable result.¹²

There is in Chapter V the analysis of the steel
industry as a result of the steel industry's growth and
further study of these factors which is presented in Chapter
production and distribution of the steel industry in the United States
ments most sensitive to price changes in the steel industry.

Production of the steel industry is discussed in Chapter VI
measured in terms of gross value added, and the steel industry's
growth of the nation and the economy for the period 1929 to 1932
approximately 110 million tons per annum. The steel industry's
effect of the price of steel on the economy is discussed in Chapter
steel companies, production was the result of a number of factors
reflected on the industrial economy. The steel industry's
"Thematic Analysis of the steel industry" is presented in Chapter
factors of production was the result of a number of factors.

¹² Robert C. Taylor, "The Steel Industry," in *Report of the National Industrial Conference Board* (United States Steel Corporation), 1932, p. 10.

¹³ "How Steel Will Change America," *United States Steel Corporation*, 1932, p. 10.

for 1956 compared with that of 1955. Comments regarding these data compose the following four paragraphs.

During the year 1956, when compared with the preceding year, the capital required per ingot ton capacity increased three per cent, or from \$77.77 to \$80.28, including a slight increase in long-term debt.

However, income for 1956 represented 11.30 per cent of capitalization compared with 12.07 per cent for 1955. Similarly, the net earnings per common share decreased from \$6.90 in 1955 to \$6.64 in 1956.

In summary, the above statistics indicate that the increasing capital requirements of the industry produce a larger income per ton produced; however, the return to the common shareholder is decreasing because of increasing operating expenses and a larger number of common shares.

The effect of the rising price level is not clearly reflected in the above statistics. Both the Consumer Price Index and the Wholesale Price Index increased during 1956 by 1.5 per cent and 3.1 per cent respectively.¹⁴ The employment costs of the steel industry increased approximately 7 per cent.¹⁵ However, the provision for

¹⁴The Consumer Price Index for 1956 was 116.2 as compared with the 114.5 for 1955; the Wholesale Price Index increased to 114.3 in 1956 from 110.7 in 1955. Indices from Survey of Current Business (February, 1958), U. S. Department of Commerce, p. 23.

¹⁵"32nd Annual Financial Analysis of the Steel Industry," Steel (April, 1957), p. 58.

depreciation increased only three tenths of one per cent. Dividends per share of common stock increased approximately fifteen per cent for 1956 when compared with 1955.¹⁶ These factors--an increased rate of dividends, a rising price level, a depreciation charge that lags behind this price level, and the resulting taxation of overstated income--tend to reduce the real capital invested in the steel industry. Such a reduction is not revealed in the financial statements because of the overstatement of reported earnings.

Rising prices affect inventory. Recognition has been given to the effect of the rising price level on inventories. Since the cost to replenish inventories is a current cost, the cost of the inventory charged to operations should also be a current cost. To accomplish this the steel companies have resorted to the Last-in First-out method of recording inventories.¹⁷ This method enables current inventory costs, rather than understated past costs, to be charged to operations.

LIFO is an acceptable method for tax purposes. The Internal Revenue Service accepted the LIFO method for federal income tax purposes in the early 1940's. The federal income tax, as far as the effect of inventory is concerned, is computed on real net income.

¹⁶Ibid., p. 58.

¹⁷Annual reports of the steel companies detailed in the Bibliography all note that inventories were carried on a Last-in First-out basis.

Tax laws, however, do not recognize a similar situation in the area of fixed assets. Depreciation of the fixed assets is not recognized in terms of current costs, but in a composite amount of past costs. If the premise of the LIFO concept is valid for short-term assets it should be equally valid for long-term assets.

Rising prices affect depreciation. Inadequate depreciation allowances have been recognized by the steel industry. The industry recognizes that costs are not properly stated and that the real values being consumed daily in the production of steel are much greater than evidenced by historical cost. Taxing authorities, too, are aware of the problem, but they have not, as yet, been willing to deal with it realistically.¹⁸

The problem arises out of the great increase in the cost of capital assets that must be purchased to replace those that wear out in order to maintain existing capacity and to continually increase the efficiency of steel-producing equipment. Table V of the Appendix, "Specific Fixed Cost Increases," reveals that the compounded rates of increase in cost per year range from 4.4 per cent to 19.6 per cent per year.¹⁹ Yet, depreciation is calculated on the cost in the year of acquisition and thereby is inadequate

¹⁸ Russell L. Peters, "Industry's Inflated Replacement Costs," An address before the Security Analysts of San Francisco, November 15, 1956 (Inland Steel Company, 1957).

¹⁹ Walker, op. cit., p. 7.

Tax laws, however, do not recognize a distinction between the
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in terms of current costs, but the depreciation is based on the original
If the premises of the fixed assets are the same as the original cost,
it should be equally valid in the long-term costs.

Rising prices affect depreciation. Investments made in the
allowance have been calculated on the basis of the original cost of the
recognizes that costs are not the same as the original cost. The
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are aware of the problem, and the original cost of the assets.
to deal with it realistically.

The problem arises out of the fact that the original cost of the
capital assets that have been purchased is not the same as the original cost
out in order to maintain the original cost of the assets. The original cost
increases the efficiency of the original cost of the assets. The original cost
the Appendix, "Specialized Fixed Asset Depreciation," reveals that the
compounded rates of interest on each year from 1920 to 1950
cent to 19.6 per cent per year. The original cost of the assets
on the cost in the year of acquisition and the original cost of the assets.

18
Russell L. Brown, "The Problem of Depreciation,"
An address before the American Institute of Accountants,
15, 1956 (Herald Street, London, E.C. 1).

to provide the funds equivalent to the capital used up. The inadequacy approximates the yearly compounded rates of increase as mentioned above. Ernest T. Weir, Chairman of National Steel Corporation, states that the eight leading steel companies reported earnings for 1956 averaging fifteen per cent on investment. "However, if proper depreciation had been charged by the industry the earnings would have been eleven-and-one-half per cent on investment rather than the fifteen per cent reported."²⁰ This misstatement of earnings, caused by not recognizing the effect of the changing price level on depreciation, misleads the public, the owners of the industry, labor, and other interested parties.

Few people realize the extent of the deficiency in depreciation.²¹ United States Steel has calculated the number of dollars of "wear and exhaustion" that would have been needed in each year since 1939 to equal the portion of the buying power originally expended which was used up in each year's production. In every year since 1939 the depreciation recorded failed to equal that needed for recovery of buying power. "The seventeen year aggregate deficiency was \$904 million. The federal income tax paid, as a

²⁰ Ernest T. Weir, "Steel Expansion: The Problems Involved," An address before the New York Society of Security Analysts, March 22, 1956 (National Steel Corporation, 1956), p. 12.

²¹ The extent by which depreciation based on historical dollars must be multiplied to recover constant purchasing power is illustrated in Table VI of the Appendix. Various rates of yearly inflation combined with various lives of assets are used as examples.

to provide the funds required for the capital expenditures
 inadequately supplemented the funds for the maintenance of the
 as mentioned above. The result was that the company's
 Corporation, stated that the right to use the funds
 reported earnings for 1939 were \$1,000,000. The company
 "However, if proper depreciation had been charged on the property
 the earnings would have been \$1,000,000 less \$1,000,000, or \$0.
 ment rather than the \$1,000,000. The company's
 ment of earnings, caused by the depreciation of the property
 changing price level, no longer reflected the true value of the
 owners of the industry, and the result was that the
 few people retained the control of the industry.
 tion. 21 United States Steel Corporation, which was one of the
 of "year and expansion" this company was one of the few
 since 1939 to equal the production of the year 1939. The
 expended which was used in the year 1939. The
 since 1939 the depreciation was \$1,000,000. The
 for recovery of buying power. The recovery was
 delinquency was \$900,000. The recovery was \$900,000.

20
 Ernest T. Kelly, General Counsel, U. S. Steel Corporation,
 an address before the New York Council on Economic Education,
 22, 1950 (National Steel Corporation, 1950, p. 10).

21
 The extent of the depreciation of the property of the
 must be calculated to recover the cost of the property
 in Table VI of the Appendix. The cost of the property
 combined with various other methods and a schedule.

result of treating this deficiency as income for tax purposes, aggregated \$608 million, twenty-two per cent of the taxes paid."²²

Rising prices affect income taxes. Income is illusory to the extent that depreciation based on current dollar values exceeds depreciation based on historical cost. The imposition of tax on this fictitious portion of "income" results in a capital levy. The \$608 million for United States Steel and analogous amounts for all other companies, large and small, may be regarded as the hidden increase in the tax rate on true income. From the latter viewpoint it is highly inequitable because it results in a burden for those industries or companies which require relatively heavier investment in longer term facilities than the average for all industry.²³

Through the years of World War II, under the provision of the Defense Production Act of 1940, a part of the steel industry's facilities were being amortized for tax purposes over a sixty-month period to allow recovery of the capital invested more rapidly than was normally permitted for tax purposes. A similar provision was enacted at the beginning of the Korean War in 1950. "Certificates of Necessity" were issued to companies engaged in necessary defense work.

²²United States Steel Corporation, Annual Report, 1956, p. 26.
(See FIGURE II of the Appendix, which graphically presents these data.)

²³Ibid., p. 27.

result of treating this category as a separate class, the aggregate \$600 million, however, is not a true aggregate.

Rising prices affect many factors, such as:

the extent that depreciation based on historical cost is a reasonable basis for depreciation based on replacement cost. The depreciation of value in this fictitious portion of the total is a serious matter.

\$600 million for United States fixed and mobile assets for all other companies, large and small, is a very small amount.

increase in the tax rate on this portion of the total is a serious matter.

it is highly inadvisable because it is a serious matter.

industries or companies which depend on the value of their assets in longer term facilities and the value of their assets.

Through the years of the war, the value of the assets of the business production has not been a serious matter.

facilities were being replaced. The war has caused a serious matter.

period so after recovery of the national income, which was rapidly increased.

was normally permitted for the recovery of the national income.

connected at the beginning of the recovery of the national income.

of necessity" were found to be a serious matter.

United States Steel Corporation, 1960, p. 100.
(See Figure 11 of the report.)

As the second of the five-year accelerated depreciation plans was declining in importance to total depreciation charges, the Internal Revenue Code of 1954 was enacted. Section 167 of the Code allows accelerated depreciation for tax purposes. The "Sum-of-the-Years-Digits" and the "Declining-Balance" methods were authorized.²⁴ These provisions of the current tax law were enacted to permit investment to be recouped in a shorter period of time, thereby reducing the impact of a changing price level on the capital invested.

Although accelerated amortization and depreciation have thus proved effective,²⁵ it must equally be recognized as a temporary expedient. For many companies the addition of amortization on new facilities to so-called regular depreciation on old facilities may approximate, temporarily, a truer total of wear and exhaustion on all facilities based on current dollar values. However, it automatically guarantees something of a future crisis.

Table IX, "Effects of Federal Income Tax" (in the Appendix), illustrates the tax effect on a hypothetical company during an inflationary trend by comparing accelerated depreciation methods with price level depreciation. Two long-term assets serve as the

²⁴Section 167, Internal Revenue Code of 1954.

²⁵Note FIGURE II of the Appendix. The accelerated depreciation and amortization provided a large part of the needed provision for United States Steel.

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²¹ Section 167, Internal Revenue Code of 1939.

²² Note PAPER II of the...
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example in showing that accelerated depreciation does not accomplish the intended purpose of price level depreciation if it were allowed for tax purposes. Although the example is limited to two assets, the resulting taxes paid illustrate that accelerated methods of depreciation are not satisfactory solutions. The taxes paid over the life of the asset, under the accelerated depreciation methods, are based on income charged with only the original dollar cost of the assets. As a result the taxes paid exceed those that would have been paid if price level depreciation were allowed for tax purposes. These excess taxes represent a levy on capital because they are not taxing real income. Regardless of the degree of acceleration, "speeded-up" depreciation methods recoup only original dollar investment. Price level depreciation, however, recoups the buying power of the original dollar investment.

As illustrated by the case of the steel industry, depreciation charges not reflecting current costs are more than a theoretical problem; its implications are far-reaching to all parts of the economy.

Financial statements of the industry. Financial statements are used by management, stockholders, prospective investors, labor, creditors, and government. The principles upon which the financial statements are based must enable the statements to report the facts fairly to every user of the statements. Selected annual reports of steel companies illustrate where present financial statements are not fairly reporting pertinent data.

Annual reports to stockholders of steel companies, as listed in the Bibliography, are typical of the industry and are similar to other corporate annual reports. These reports contain financial statements showing results of operations for 1956 and the financial condition of the company as of the year ended December 31, 1956.

A review of these financial statements emphasizes three points applicable to the effect of the changing price level on financial statements:

1. Statements of income reported current costs with the exception of depreciation charges. Depreciation charges were a group of past costs being matched and compared with current costs and income. For example, United States Steel reported "wear and exhaustion of facilities" of \$277,598,963, or approximately eight per cent of total costs. This amount was understated by \$67,000,000;²⁶ which would then account for approximately nine per cent of total cost.²⁷

2. Presentation of the conventional balance sheet has changed in recent years. Many companies do not show the total of the assets and the corresponding figure of total liabilities and net worth. The companies that presented these figures in statement form did not label them. The balancing figures are not representative of total assets as stated in today's dollars, or as stated in any other constant unit of measurement. The same is true for total liabilities and net worth. Therefore, to label the totals would be misleading because the numbers themselves are misleading.

3. Comparative results are presented below based on the Annual Report of United States Steel for 1956. The table illustrates the effect of a major problem caused by a changing price level.

²⁶Ibid., p. 28.

²⁷FIGURE II of Appendix shows deficiency of depreciation charge from 1940-1956.

	As Reported to Stockholders	Adjusted for Depreciation Based on the 1956 Price Level (Tax Law Not Recogniz- ing Adjustment)	If Tax Law Recognized Adjustment
Income before taxes	\$ 679,098,916	\$ 612,098,916 ²⁸	\$ 612,098,916
Taxes on income	<u>331,000,000</u>	<u>331,000,000</u>	<u>296,516,000²⁹</u>
Net income	\$ 348,098,916	\$ 281,098,916	\$ 315,582,916
Dividends declared	<u>170,103,878</u>	<u>170,103,878</u>	<u>170,103,878</u>
Income reinvested in the business	\$ <u>177,995,038</u>	\$ <u>110,995,038</u>	\$ <u>145,479,038</u>

²⁸The Company has for a number of years followed the policy of reflecting accelerated depreciation on the cost of new facilities in the first few years of their lives when the economic usefulness is greatest. Therefore, the \$67,000,000 price level adjustment is in addition to and independent of the accelerated depreciation.

²⁹If the tax law were revised to permit a deduction of depreciation based on the 1956 price level the taxes would approximate the amount calculated below:

Understatement of depreciation per <u>Annual Report</u> of United States Steel	\$ 67,000,000
Corporate federal income tax rate for 1956	<u>52%</u>
Tax saving attributable to adjusted depreciation	\$ (34,840,000)
Taxes before depreciation adjustment	<u>331,000,000</u>
Taxes on income after depreciation adjustment	\$ <u>296,516,000</u>

Income before taxes	\$ 12,000.00	\$ 12,000.00	\$ 12,000.00
Taxes on income	1,000.00	1,000.00	1,000.00
Net income	11,000.00	11,000.00	11,000.00
Dividends declared	11,000.00	11,000.00	11,000.00
Income retained in the business	0.00	0.00	0.00

28 The Company has for a number of years been engaged in the business of reflecting in its financial statements the results of its operations in the form of dividends and retained earnings. In the first few years of its existence, the Company was engaged in the business of reflecting in its financial statements the results of its operations in the form of dividends and retained earnings. In addition to the dividends and retained earnings, the Company has also been engaged in the business of reflecting in its financial statements the results of its operations in the form of dividends and retained earnings.

29 It is the policy of the Company to pay dividends to its shareholders in cash. The Company has been engaged in the business of reflecting in its financial statements the results of its operations in the form of dividends and retained earnings. In addition to the dividends and retained earnings, the Company has also been engaged in the business of reflecting in its financial statements the results of its operations in the form of dividends and retained earnings.

Statement of Retained Earnings			
Balance at beginning of year	\$ 10,000.00	\$ 10,000.00	\$ 10,000.00
Net income	11,000.00	11,000.00	11,000.00
Dividends declared	11,000.00	11,000.00	11,000.00
Balance at end of year	\$ 10,000.00	\$ 10,000.00	\$ 10,000.00

Under the present tax law, regardless of whether the adjustment for the change in price level is made, the income actually reinvested in the business is the same. One method is informative-- the other misleading.

While the adjustment of depreciation admittedly loses much of its value if disallowed for tax purposes, the question remains whether management is justified in adopting it for its own accounting in the absence of tax benefit. The writer believes it is.

A proper accounting of depreciation is essential for the correct determination of costs, and consequently, of net income. The overstatement of profits inherent in original-cost depreciation at the present time not only gives the impression to the public, including organized labor, that the enterprise is making more than it really is; because of stockholder pressure it is likely to lead to dividend payments that would not occur if the true facts were recognized. Moreover, the understatement of costs may lead to the underpricing of the product.

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CHAPTER VI

USEFUL FINANCIAL STATEMENTS ESSENTIAL FOR A DYNAMIC ECONOMY

A new kind of inflation. During World War II the United States' economy experienced the old phenomenon of money increasing far faster than the marketable production on which to spend it. The material result was an upward inflationary pull on wages and prices despite wartime controls. This could be understood as inflation originating in monetary and fiscal policy deemed necessary in wartime. It is in the years since the war that evidence has accumulated that a new kind of inflation has developed.

The new kind of inflation appears to be cost inflation pushing prices up, rather than price inflation pulling up costs through competitive bidding for materials and manpower. "We might think of it as a new 'cost-push' type of inflation."¹

Prices evidence the new kind of inflation. Following previous great wars prices declined from the inflated level of the last war year. The record since the close of World War II has been quite different. As evidenced by the indices published by the U. S.

¹ Robert C. Tyson, "Our New Kind of Inflation," An address before the National Industrial Conference Board, May 16, 1957 (United States Steel Corporation, 1957), p. 2.

Department of Commerce, instead of a downward adjustment there has been further marked inflation for more than a decade following the end of the war.

The evidence of wage-cost inflation is even more disturbing and impressive. Both World Wars gave impetus to wage inflation. The impetus carried on for two years after the close of World War I and then stability reappeared. A decade later, in 1929, the average wage in the steel industry was within one or two per cent of the 1920 level.² The experience after World War II has been vastly different. Each year since the end of the war wage inflation has continued.

While it is not within the scope of this thesis to analyze the recent inflation a few comments are in order since the terms "cost-push" and "wage inflation" might be misnomers.

Description of the recent inflation as a "cost-push" inflation is based primarily on the relationship of wages to productivity. Increases in productivity have the effect of reducing the quantity of labor needed to produce a unit of product; if the increased price of labor does not more than offset the reduction in quantity of labor, then there is no need for the price of the product to be increased. However, as illustrated on FIGURE III of the Appendix, average hourly earnings of factory workers have advanced more

² Ibid., p. 3.

Department of Justice, Bureau of Labor Statistics, has been working for some time on a study of the cost of living in the United States.

The study is being conducted in order to determine the effect of changes in the cost of living on the purchasing power of the dollar. The study is being conducted in order to determine the effect of changes in the cost of living on the purchasing power of the dollar. The study is being conducted in order to determine the effect of changes in the cost of living on the purchasing power of the dollar.

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rapidly than productivity, particularly since 1950. Although the Bureau of Labor Statistics' estimates of productivity are limited by the assumptions and procedures used in their compilation, they are indicative and approximate the trend of manufacturing productivity.³

J. W. Garbarino, of the University of California, interprets the Bureau of Labor Statistics' estimates as an increase in output per man-hour ranging between three and three-and-one-half per cent per year since 1953. He estimates that total employment costs (hourly earnings plus fringe benefits) have increased about five per cent per year during the same period. He concludes that at least part of the price increase, as illustrated in FIGURE IV of the Appendix as the wholesale price of finished goods, was attributable to the pressure of wage increases.⁴

Organized labor is not the entire cause of recent large wage increases. Business management has tended to avoid interruption of production and has, therefore, granted larger wage increases at the bargaining tables to permit production to continue without interruption. Management has been more willing to avoid interruption

³J. W. Garbarino, "Wages, Productivity and Inflation," Management Record (August, 1957), p. 266.

⁴Ibid., p. 267.

⁵Leland Hazard, "Management Action on Wage Inflation," Management Record (August, 1957), p. 273.

rapidly than previously, and the Bureau of Labor Statistics has estimated that by the end of 1937 the number of persons employed in the United States will be approximately 40,000,000. This increase in the number of persons employed is due to the fact that the number of persons employed in the United States has increased steadily since 1920, and it is expected that this increase will continue for some time to come.

The Bureau of Labor Statistics has also estimated that the number of persons employed in the United States will be approximately 40,000,000 by the end of 1937. This increase in the number of persons employed is due to the fact that the number of persons employed in the United States has increased steadily since 1920, and it is expected that this increase will continue for some time to come.

The Bureau of Labor Statistics has also estimated that the number of persons employed in the United States will be approximately 40,000,000 by the end of 1937. This increase in the number of persons employed is due to the fact that the number of persons employed in the United States has increased steadily since 1920, and it is expected that this increase will continue for some time to come.

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Management Bureau, Bureau of Labor Statistics, U.S. Department of Labor, Washington, D.C.

1. The Bureau of Labor Statistics has estimated that the number of persons employed in the United States will be approximately 40,000,000 by the end of 1937. This increase in the number of persons employed is due to the fact that the number of persons employed in the United States has increased steadily since 1920, and it is expected that this increase will continue for some time to come.

2. The Bureau of Labor Statistics has also estimated that the number of persons employed in the United States will be approximately 40,000,000 by the end of 1937. This increase in the number of persons employed is due to the fact that the number of persons employed in the United States has increased steadily since 1920, and it is expected that this increase will continue for some time to come.

because of the overstated profits caused by the rising price level. With the present tax rates management realizes that the government will pay, in effect, fifty-two per cent of the wage increases.

One must recognize that it is difficult to determine if costs and wage increases are causing inflation or if they are being caused by inflation.

Prospects of a continuing "new kind of inflation" are not accurately predictable. Basically the problem is not how to live with the inflation but of obtaining an adequate analysis of the problem and then seeking a remedy. Such a remedy must realize that the injustice of inflation is that it afflicts different economic groups very unequally. This fact should always be taken into account when remedies are sought, but commonly is not.⁶

Government's economic policies. Fiscal policies of the federal government must be continuously revised to be compatible with the dynamic national economy. These policies must recognize the changing economic framework. Principally, the Federal Reserve's monetary policies, the national debt, and the taxation laws determined by Congress are the policies that have the major impact on inflationary pressures.

The Federal Reserve is obliged to limit credit when increased

⁶ Thomas H. Sanders, "Inflation and Accounting," Harvard Business Review (May-June, 1952), p. 57.

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demands by borrowers would add greatly to inflationary pressures without adding to the supply of goods.⁷ Operations of the Federal Reserve in creating or extinguishing bank reserves exert a powerful influence on the flow of credit and money. These operations are discount operations, open market operations, and changes in reserve requirements. The first two are generally more flexible and more adaptable in short-term changes in credit and monetary conditions than the third. The timing of the use of all three methods and their coordination are of extreme importance in Federal Reserve policy during periods of changing prices.⁸

Help in the fight against inflation could be rendered by the federal government by learning to live within its income. Deficit spending in periods of inflation greatly adds to inflationary pressures, whereas by creating a surplus, part of the money in the economy that is causing inflation is extracted.⁹

Congress could also help, especially by enacting tax laws that tax only income and not capital. "Business will perform its tasks if given the right kind of government backing. It cannot

⁷"Creeping Inflation: The Pickpocket of Prosperity," Business Review (August, 1957), p. 11.

⁸The Federal Reserve System, (Washington, D. C.: Board of Governors of the Federal Reserve System, 1954), p. 31.

⁹"Creeping Inflation," op. cit., p. 12.

demands by business and industry for a more liberal
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in exercising its power to issue currency and to
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perform them if it is obstructed by policies which are designed deliberately or unwittingly to destroy private enterprise itself."¹⁰ In the absence of assistance from Congress, businessmen can work together in reforming accounting practice to recognize that portion of our wealth which constitutes capital and that portion which constitutes income, with the view to maintaining capital intact and limiting consumption to only a portion of income.¹¹

Informative financial statements. Disclosure of pertinent and truthful data in financial statements is essential for a progressive and dynamic economy. The accounting "principles" upon which these financial statements are based must be subjected to continued review to assure those that are utilizing these financial data that the data are accurate and that the statements disclose the pertinent financial facts. Such a review is the responsibility of the accounting profession. Had this responsibility been accepted in the past the effects of the changing price level would be disclosed in today's financial statements.

Data that are reported in financial statements are interpreted and used by management, investors, labor, government agencies, and the general public in making important decisions. Since the United

¹⁰ Sanders, op. cit., p. 58.

¹¹ Percival Brundage, "Price Level Changes--Effect on Income," Journal of Accountancy (February, 1952), p. 190.

perform them it is in accordance with the law and
deliberately on matters which are of public concern
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together in reference to the same. It is the duty
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Data from the present financial statements are
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States' economy is diversified and interrelated, the decisions made by any one of the above groups directly or indirectly affects every other group.

Unless the data as reported in the financial statements reveals the "real" status of net assets and net income, management might incorrectly price its product, labor might demand unjustified wage increases, investors might unwisely invest their capital, government agencies might levy unfair taxes, and the general public might support policies that are detrimental to a high standard of living.

Informative financial statements are imperative.

Useful financial statements for the steel industry. As noted in Chapter V, financial statements of the steel companies do not adequately report the effect of the changing price level. Many non-accounting problems confronting the industry are in part attributable to financial statements not reflecting the changing price level.

An expanding economy, a steadily climbing standard of living, an increasing population, a tense international situation, all point to the demand that will be placed upon the steel industry in the 1960's for increased production. Unless the steel industry can expand its capacity to produce the necessary steel, the growth of the economy and the American standard of living might be retarded.

Seafarers' earnings is distributed in a proportionate manner by way of the share of the profits of the company, which is distributed to the other groups.

Unless the ship is engaged in the transport of goods, it reveals the "cost" of the ship's operation and the income it might generate. It is not possible to determine the exact wage increase, because the ship's operation is not a simple matter. Government regulations, such as the requirement that the ship must be registered in a particular country, might support policies that are aimed at increasing the living.

Under the present system, the ship's operation is not a simple matter. It is not possible to determine the exact wage increase, because the ship's operation is not a simple matter. Government regulations, such as the requirement that the ship must be registered in a particular country, might support policies that are aimed at increasing the living.

price level. An expansion of the money supply, a rise in the price level, and an increase in the demand for money, all of which are aimed at increasing the living, are all aimed at increasing the living. The demand for money is aimed at increasing the living. The demand for money is aimed at increasing the living.

Before additional capacity can be added, the existing plant must be maintained by replacing worn-out equipment. Conventional depreciation charges against income do not recover the purchasing power of the investment in plant. Consequently management must supplement the funds provided by depreciation by allocating a part of the earnings for the replacement of existing plant. Such an allocation thereby limits the funds available for expansion.

Since earnings must be used in part to replace plant and equipment that are wearing out, and since new capital will not be readily available, the steel industry needs financial statements that report economic facts as they exist; not as conventional accounting principles report them. With factual financial statements the public and the taxing authorities will be apprised of the serious obstacle to the steel industry's expansion, which will provide a basis for intelligent legislation to tax only real income and not capital. Labor will also be apprised of the real income of the corporations which will enable the unions to base wage demands on real income, not on overstated income caused by rising prices against which inadequate provisions in expense accounting have been made.

Conclusion. It is apparent from the evidence presented in this thesis that financial statements, prepared according to present accounting practices, do not report current costs or current income. This failure to reflect changes in the purchasing power of the dollar

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in financial statements has caused undesirable social and economic effects. Without adjustment for price level changes, basic management decisions such as pricing and investment may be based on erroneous cost data that reflects past dollars. On the basis of published financial statements, employee groups have often concluded that ample profits were earned from which wage increases could be paid without necessitating price increases. Stockholders have frequently expressed dissatisfaction with the current rate of dividends and have pointed to the large retained dollar earnings as a source of cash dividends.

Accounting problems occasioned by the recent inflation will undoubtedly continue in the future. Similar problems arise during depressions. Accountants and businessmen who are concerned with the preparation of accounting reports need a unified concept of business income, and should know how to implement it when prices are changing. This is an area calling for continued education of accountants and businessmen.

Greater significance, comparability, and accuracy in financial reporting would be attained if financial statements reflected the changing purchasing power of the dollar. The benefits that would be derived for the economy as a whole will far outweigh the initial difficulties likely to be encountered in implementing financial reporting based on costs adjusted for price level changes. It would be advisable for all companies to adopt the revised method of

financial reporting at the same time. Comparability and full disclosure would be attained consistently throughout the economy. Without this, even more misinterpretation of financial statements is likely to occur.

Appropriate changes should also be made in tax laws to allow the use of adjustments to historical costs by means of an index of the general price level. Business enterprises would be treated similarly by coming closer to taxing real, economic income, thereby preventing the confiscation of capital.

The implications of revised reports are far-reaching. Accounting problems of inflation and deflation are a part of the broader ones of changing prices in general. If businessmen and accountants succeed in adopting a method of reporting which approximates a measure of real income, it may be a great stride forward in solving some of the non-accounting problems of price changes.

It seems proper that a meaningful approach to income determination should be initiated by the supposed experts in this area--the accountants. An analysis of the implications of a revised concept of accounting income is beyond the scope of this thesis; it will be for others to study the results of reporting currently the effects of the changing price level. It is the responsibility of management and the accounting profession to take the initial step by presenting realistic current data in financial statements.

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APPENDIX

EFFICIENCY
EFTSABLE BOND
RAG CONTACT

ELFICRNOY
ERASABLE BOND
RAB CONTENT

APPENDIX A

ROLE OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities Act of 1933 and the Securities Exchange Act of 1934 require for various reasons presentation of financial information in conformity with standards of disclosure set up by the Securities and Exchange Commission. Among other things the Commission requires is that provisions for depreciation and depletion be clearly reflected in financial statements.¹

The securities acts are designed to protect investors by making available to them information from which they may better judge the value of securities offered to them or which they already hold. A corollary of this is, of course, the protection of investors against false or misleading information on any material fact. Many believe that for these purposes realistic reflection of earnings or net income of a corporation requires adjustments for changes in the value of the dollar since comparison of values at different dates is involved. This would include making such an adjustment in measuring exhaustion of physical property during a given accounting period and making provision for

¹ See Regulation S-X Rules 3-20 (c), 5.02 (14), 5.04, issued under the Securities Act of 1933 and the Securities Exchange of 1934.

ROLE OF THE SECURITIES ACT OF 1933

The Securities Act of 1933, and the Securities Exchange Act of 1934, together with the Securities and Exchange Commission, have been instrumental in the development of the securities market. The Commission requires that all securities be registered with it, and that all securities be sold through a registered broker or dealer. This has resulted in a more orderly and transparent market, and has helped to protect investors from fraud and other abuses.

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¹ See Regulation D, 17 C.F.R. 230.230-1, 230.230-2, 230.230-3, 230.230-4, 230.230-5, 230.230-6, 230.230-7, 230.230-8, 230.230-9, 230.230-10, 230.230-11, 230.230-12, 230.230-13, 230.230-14, 230.230-15, 230.230-16, 230.230-17, 230.230-18, 230.230-19, 230.230-20, 230.230-21, 230.230-22, 230.230-23, 230.230-24, 230.230-25, 230.230-26, 230.230-27, 230.230-28, 230.230-29, 230.230-30, 230.230-31, 230.230-32, 230.230-33, 230.230-34, 230.230-35, 230.230-36, 230.230-37, 230.230-38, 230.230-39, 230.230-40, 230.230-41, 230.230-42, 230.230-43, 230.230-44, 230.230-45, 230.230-46, 230.230-47, 230.230-48, 230.230-49, 230.230-50, 230.230-51, 230.230-52, 230.230-53, 230.230-54, 230.230-55, 230.230-56, 230.230-57, 230.230-58, 230.230-59, 230.230-60, 230.230-61, 230.230-62, 230.230-63, 230.230-64, 230.230-65, 230.230-66, 230.230-67, 230.230-68, 230.230-69, 230.230-70, 230.230-71, 230.230-72, 230.230-73, 230.230-74, 230.230-75, 230.230-76, 230.230-77, 230.230-78, 230.230-79, 230.230-80, 230.230-81, 230.230-82, 230.230-83, 230.230-84, 230.230-85, 230.230-86, 230.230-87, 230.230-88, 230.230-89, 230.230-90, 230.230-91, 230.230-92, 230.230-93, 230.230-94, 230.230-95, 230.230-96, 230.230-97, 230.230-98, 230.230-99, 230.230-100.

such exhaustion.²

As yet, the SEC has issued no rule requiring adjustments for change in the value of the dollar nor has it disapproved for lack of such adjustment any financial statements submitted to it as part of registration statements and prospectuses or as part of Form 10-K in annual reports. On the contrary, when United States Steel Corporation in its 10-K reports for 1947 and 1948 attempted to provide for changes in the value of the dollar in determining provisions for depreciation, the SEC refused approval, although it has approved depreciation provisions in an equal amount when explained as an acceleration of a portion of the unadjusted original cost, taken as an operating expense in the particular year. The company subsequently amended its accounts to conform to this view.

² Arthur H. Dean, "Provision for Capital Exhaustion under Changing Price Levels," Harvard Law Review (June, 1952), p. 1345.

APPENDIX B

PRICE LEVEL DEPRECIATION QUESTIONNAIRE

PREPARED BY AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS TO
ASCERTAIN MANAGEMENT'S OPINION OF MODIFYING CORPORATE REPORTS

1. In view of changes in price levels, and assuming for the purposes of this question that an acceptable means of measuring such changes is available, do you think that the current dollar cost of depreciation should be reflected in some appropriate manner in corporate reports to stockholders?

2. If your answer to question 1 is "yes," which of the following methods do you consider acceptable:

a. Report net income in the presently accepted manner with an explanatory footnote disclosing cost of depreciation in current dollars.

b. Report net income in the presently accepted manner, accompanied by a supplementary statement which reflects current dollar cost of depreciation and the adjusted net income.

c. Show in the income statement the amount of depreciation based upon historical cost and, as an additional item, an amount to bring the total charge for depreciation up to the current cost basis. Net income would be reported after the full current cost deduction and the additional provision would be carried to a property replacement reserve.

d. Adjust both the balance sheet and the income statement to show current cost and historical cost of plant and equipment and their depreciation. Net income would be reported after the full current cost of depreciation.

Which of the above methods do you prefer. (Circle your preference.)

3. If you think the effect of price level changes should be recognized, do you believe there should be a mandatory requirement for disclosing the amount of current dollar cost of depreciation?

ARTICLE 1

SECTION 1. TITLE

PREPARED BY AMERICAN ...

ASSOCIATION ...

1. In view of ... the purpose of ...

2. It is the ... the following ...

3. ... of ...

4. ...

5. ...

6. ...

7. ...

8. ...

4. Would you favor reporting to stockholders a figure for net income which reflects charges for current cost depreciation, if current cost depreciation were accepted for income tax purposes?

5. Would you favor reporting to stockholders a figure for net income which reflects charges for current cost depreciation, even if current cost depreciation were not accepted for tax purposes?

6. Do you believe that technological changes in the productivity of new plants counterbalance the effect of rising price levels?

7. Do you feel that the large program of capital additions which most companies have undertaken in recent years has for practical purposes taken care of the price-level problem?

Source: American Institute of Certified Public Accountants, July 23, 1957.

TABLE I
CONSUMER PRICE INDEX

1913 TO 1956

BASE PERIOD 1947-49 = 100

<u>Year</u>	<u>Index</u>	<u>Year</u>	<u>Index</u>
1913	42.3	1936	59.3
1914	42.9	1937	61.4
1915	43.4	1938	60.3
1916	46.6	1939	59.4
1917	54.8	1940	59.9
1918	64.3	1941	62.9
1919	74.0	1942	69.7
1920	85.7	1943	74.0
1921	76.4	1944	75.2
1922	71.6	1945	76.9
1923	72.9	1946	83.4
1924	73.1	1947	95.5
1925	75.0	1948	102.8
1926	75.6	1949	101.8
1927	74.2	1950	102.8
1928	73.3	1951	111.0
1929	73.3	1952	113.5
1930	71.4	1953	114.4
1931	65.0	1954	114.8
1932	58.4	1955	114.5
1933	55.3	1956	116.2
1934	57.2		
1935	58.7		

SOURCE: Statistical Abstract of the United States, 1957,
78TH Annual Edition (U. S. Department of Commerce,
 Washington, D. C.), p. 328, No. 400.

TABLE II
PURCHASING POWER OF THE DOLLAR
1935 TO 1956
BASE PERIOD 1947-49 = 100

Year	Monthly Average Measured By		Year	Monthly Average Measured By	
	Wholesale Prices	Consumer Prices		Wholesale Prices	Consumer Prices
1935	192.3	170.4	1946	127.1	119.9
1936	190.5	168.6	1947	103.7	104.7
1937	178.3	162.9	1948	95.8	97.3
1938	195.7	165.8	1949	100.8	98.2
1939	199.6	168.4	1950	97.0	97.3
1940	195.7	166.9	1951	87.1	90.1
1941	176.1	159.0	1952	89.6	88.1
1942	155.8	143.5	1953	90.8	87.4
1943	149.3	135.1	1954	90.7	87.1
1944	147.9	133.0	1955	90.3	87.3
1945	145.3	130.0	1956	87.5	86.1

SOURCE: Statistical Abstract of the United States, 1957, 78TH Annual Edition (U. S. Department of Commerce, Washington, D. C.), p. 327, No. 399.

TABLE II

Monthly average wholesale prices of selected commodities, 1915-1935

1915 = 100

Year	Wholesale prices of selected commodities	Monthly average
1935	100.0	100.0
1934	98.5	98.5
1933	97.0	97.0
1932	95.5	95.5
1931	94.0	94.0
1930	92.5	92.5
1929	91.0	91.0
1928	89.5	89.5
1927	88.0	88.0
1926	86.5	86.5
1925	85.0	85.0
1924	83.5	83.5
1923	82.0	82.0
1922	80.5	80.5
1921	79.0	79.0
1920	77.5	77.5
1919	76.0	76.0
1918	74.5	74.5
1917	73.0	73.0
1916	71.5	71.5
1915	70.0	70.0

SOURCE: Statistical Abstract of the United States, 1936, Table 1001, p. 1001.

TABLE III
GROSS NATIONAL PRODUCT--CURRENT DOLLARS
COMPARED TO CONSTANT (1947) DOLLARS¹
1929 TO 1956

<u>Selected Years</u>	<u>Current Dollars</u>	<u>Constant Dollars</u> 1947 Prices
	<u>(In Millions of Dollars)</u>	
1929	104,436	149,300
1933	55,964	103,700
1940	100,618	171,600
1945	213,558	263,100
1950	285,067	264,700
1952	345,445	293,700
1953	363,218	305,300
1954	360,654	300,800
1955	390,860	322,400
1956	412,400	330,300

¹ Constant dollar figures were obtained by dividing current-dollar estimates shown in Table No. 361 by appropriate price indices based on 1947 as 100, in order to eliminate from the current dollar estimate all price change as compared with 1947.

SOURCE: Statistical Abstract of the United States, 1957,
78TH Annual Edition (U. S. Department of Commerce,
Washington, D. C.), pp. 296-297, No. 360 and No.
361.

TABLE 1

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY

1945-1946

Selected Items	1945	1946
Wheat, hard red winter, No. 1, bushels	1.15	1.10
Wheat, soft red winter, No. 1, bushels	1.10	1.05
Wheat, durum, No. 1, bushels	1.10	1.05
Wheat, hard red spring, No. 1, bushels	1.10	1.05
Wheat, soft red spring, No. 1, bushels	1.10	1.05
Wheat, durum, No. 1, bushels	1.10	1.05
Wheat, hard red winter, No. 2, bushels	1.05	1.00
Wheat, soft red winter, No. 2, bushels	1.05	1.00
Wheat, durum, No. 2, bushels	1.05	1.00
Wheat, hard red spring, No. 2, bushels	1.05	1.00
Wheat, soft red spring, No. 2, bushels	1.05	1.00
Wheat, durum, No. 2, bushels	1.05	1.00
Wheat, hard red winter, No. 3, bushels	1.00	0.95
Wheat, soft red winter, No. 3, bushels	1.00	0.95
Wheat, durum, No. 3, bushels	1.00	0.95
Wheat, hard red spring, No. 3, bushels	1.00	0.95
Wheat, soft red spring, No. 3, bushels	1.00	0.95
Wheat, durum, No. 3, bushels	1.00	0.95

1. Current dollar prices are based on the current dollar price of the commodity in the United States. The current dollar price of a commodity is the price of the commodity in the United States, expressed in terms of the current dollar. The current dollar price of a commodity is the price of the commodity in the United States, expressed in terms of the current dollar.

Source: U.S. Department of Agriculture, Office of the Secretary, Washington, D.C., 1945-1946. The current dollar price of a commodity is the price of the commodity in the United States, expressed in terms of the current dollar.

TABLE IV
EXPENDITURES REQUIRED TO
"STAY-EVEN" ASSUMING PRICE
INCREASES OF SEVEN PER CENT PER YEAR

<u>Year of Expenditure</u>	<u>Factor</u>	<u>Amount</u>
1st (1940)	1.00	\$ 1.00
2nd (1941)	1.07	1.07
3rd (1942)	1.07 ²	1.14
15th (1954)	1.07 ¹⁴	2.58
25th (1964)	1.07 ²⁴	<u>5.07</u>

If the intervening years
were filled in, the
total would be \$63.25

which would be the current
dollar equivalent of each
dollar spent at the beginning
of the twenty-five year period.

SOURCE: "Inadequate Depreciation in the Metals
Manufacturing Industry," A technical paper
by W. A. Walker (United States Steel
Corporation, 1956), p. 7.

NOTE: See Chapter V for additional information
regarding expenditures required to "stay-
even."

TABLE II
 EXPENDITURES FOR RESEARCH AND DEVELOPMENT
 1950-1954
 (In millions of dollars)

Year of Expenditure	1950	1951	1952	1953	1954
1st (1950)	1.0	1.0	1.0	1.0	1.0
2nd (1951)	1.0	1.0	1.0	1.0	1.0
3rd (1952)	1.0	1.0	1.0	1.0	1.0
4th (1953)	1.0	1.0	1.0	1.0	1.0
5th (1954)	1.0	1.0	1.0	1.0	1.0

If the expenditures were divided by the number of years, the average would be 1.0 million dollars per year.

SOURCE: "Independent Review of the National Science Foundation," by W. S. Hoar, National Science Foundation, 1954.

NOTE: See Chapter 2 for a discussion of the importance of research and development in the economy.

TABLE V
SPECIFIC FIXED ASSET COST INCREASES

<u>Asset</u>	<u>Original Year</u>	<u>Latest Year</u>	<u>Per Cent of Cost Increase Per Year (Simple Average)</u>
100 Ton Ladle	1912	1956	5.0
Structural Mill & Aux.	1926	1956	4.4
6 Stand Billet Mill	1925	1951	5.5
Blast Furnace	1948	1952	19.6
O. H. Charging Machine	1929	1951	6.9
Electrolytic Cleaning Line	1946	1951	16.5
Boring Mill	1945	1956	7.7
Coke Battery	1927	1952	5.6
Cold Reduction Mill	1940	1950	8.9
1750 hp Reversing Motor	1945	1955	7.8

SOURCE: "Inadequate Depreciation in the Metals Manufacturing Industry," A technical paper by W. A. Walker (United States Steel Corporation, 1956), p. 3.

Asset	Quantity	Unit Price	Total Value
100 Ton Lignite	100	1.25	125.00
Stromberg Mill & Co.	100	1.25	125.00
6 Speed Electric Mill	100	1.25	125.00
Blair Furnace	100	1.25	125.00
O. H. Chandler Machine	100	1.25	125.00
Electricity & Heating Plant	100	1.25	125.00
Power Mill	100	1.25	125.00
Coke Battery	100	1.25	125.00
Coal Refractory Mill	100	1.25	125.00
1750 hp Generator	100	1.25	125.00

SOURCE:
 THE CONTENTS
 OF THIS REPORT
 ARE NOT TO BE
 USED FOR ANY
 OTHER PURPOSE
 WITHOUT THE
 WRITTEN CONSENT
 OF THE BUREAU
 OF MINES

TABLE VI
EXTENT TO WHICH DEPRECIATION ON HISTORICAL
DOLLARS MUST BE MULTIPLIED TO RECOVER
CONSTANT PURCHASING POWER

Rate of Inflation Per Year	Factor		
	5-Year Life	10-Year Life	25-Year Life
5%	1.16 Times	1.30 Times	1.77 Times
6%	1.19 Times	1.36 Times	1.96 Times
7%	1.22 Times	1.42 Times	2.15 Times
8%	1.25 Times	1.49 Times	2.34 Times

SOURCE: "Inadequate Depreciation in the Metals Manufacturing Industry," A technical paper by W. A. Walker (United States Steel Corporation, 1956), p. 7.

NA = Not available

The source presented this table as a measure of the extent to which the depreciation on historical dollars must be multiplied to recover constant purchasing power of steel during the thirty-year period.

Factor

SOURCE: "Steel Industry," p. 100, U.S. Steel Corporation, 1956.

THE UNITED STATES OF AMERICA
DOES HEREBY CERTIFY THAT
THE FOLLOWING IS A TRUE AND CORRECT
TRANSLATION OF THE ORIGINAL

Rate of Inflation per Year		Year	
5%	1967	1967	1967
6%	1968	1968	1968
7%	1969	1969	1969
8%	1970	1970	1970

SOURCE: "Independent" press release in the Soviet Union
regarding "a certain and rapid" increase in
Soviet steel production, 1970.

TABLE VII
FINANCIAL ANALYSIS OF THE STEEL INDUSTRY
FOR 1956¹

	Ingot Prod. Net Tons		Net Income Per Ton of Ingots Produced		Capitalization Per Ton Ingot Capacity	
	1956	1955	1956	1955	1956	1955
U. S. Steel	33,402,000	35,309,000	\$10.42	\$10.48	\$ 76.02	\$73.15
Bethlehem Steel	18,322,308	18,820,912	8.81	9.57	80.42	79.74
Republic Steel	9,348,898	9,680,121	9.67	8.91	63.21	63.35
Jones & Laughlin	5,997,000	6,190,000	7.52	8.09	88.09	85.33
Youngstown Sheet & Tube	5,406,016	5,571,556	7.99	7.48	79.82	80.50
National Steel	NA*	NA	NA	NA	88.72	75.49
Armco Steel	5,220,147	5,099,905	12.57	12.62	80.72	86.22
Inland Steel	4,915,576	5,189,509	10.78	10.11	95.72	83.28
Colorado Fuel & Iron	2,401,231	1,936,402	6.94	5.62	76.55	69.82

Total or average of thirty-three steel producers: (See below)

100,926,871 104,236,963 \$ 9.82 \$ 9.57 \$ 80.28 \$77.77

NA = Not available.

¹The analysis included data from thirty-three producers of steel which presented 93.34 per cent of the steelmaking capacity of the United States. This table presents the companies that produced over two million ingot tons of steel during 1957; the total or average figures are based on the total of the thirty-three companies.

²After federal income taxes but before interest on long-term debt.

SOURCE: "32ND Annual Financial Analysis of the Steel Industry," Steel (April, 1957), p. 59.

TABLE VII
FINANCIAL ANALYSIS OF THE STEEL INDUSTRY
FOR 1956¹

	Ingot Prod., Net Tons		Net Income Per Ton of Ingots Produced		Capitalization per Ton Ingot Capacity	
	1956	1955	1956	1955	1956	1955
U. S. Steel	33,102,000	32,302,000	\$10.12	\$10.18	\$76.02	\$73.12
Bethlehem Steel	18,322,308	18,820,912	8.81	9.27	80.12	79.74
Republic Steel	9,348,898	9,680,121	9.67	8.91	69.21	69.32
Jones & Laughlin	2,927,000	6,190,000	7.22	8.02	88.02	82.33
Youngstown Sheet & Tube	2,406,076	2,271,226	7.92	7.48	79.82	80.20
National Steel	NA	NA	NA	NA	88.72	72.42
Armco Steel	2,220,117	2,022,202	12.27	12.62	80.72	86.22
Inland Steel	1,912,216	2,182,202	10.78	10.11	92.72	83.28
Colorado Fuel & Iron	2,401,231	1,936,102	6.91	2.62	76.22	69.82

Total or average of thirty-three steel producers: (see below)

100,226,871	10,236,963	\$ 9.82	\$ 9.27	\$ 80.28	\$ 77.77
-------------	------------	---------	---------	----------	----------

NA = Not available.

¹The analysis included data from thirty-three producers of steel which presented 93.31 per cent of the steelmaking capacity of the United States. This table presents the companies that produced over two million ingot tons of steel during 1957; the total or average figures are based on the total of the thirty-three companies.

²After federal income taxes but before interest on long-term debt.

TABLE VIII

UNITED STATES STEEL CORPORATION

RECORDED VS. WAR AND RECONSTRUCTION

1940-1955

(Millions of Dollars)

Provision for Depreciation or Depletion		Total Income % of Capitalization ²		Long-Term Debt (Excluding Amt. Maturing in One Year)		Net Earnings Per Common Share		Dividends Per Common Share		Total Employment Costs	
1956	1955	1956	1955	1956	1955	1956	1955	1956	1955	1956	1955
\$277,598,963	\$285,199,386	11.82	13.22	\$235,023,677	\$286,083,534	\$ 6.01	\$ 6.45	\$ 2.70	\$2.30		
102,459,454	102,653,998	10.66	12.38	278,621,000	336,904,500	15.33	18.09	8.50	7.25		
43,059,441	45,472,391	13.13	13.57	40,754,784	440,029,724	5.83	5.59	2.63	2.50		
37,009,000	37,021,000	8.35	10.19	130,275,000	105,473,000	6.63	7.73	2.50	2.25		
41,520,330	41,217,490	9.66	10.03	98,750,000	100,000,000	12.62	12.34	4.50	3.75		
45,344,338	40,235,237	10.26	11.05	110,000,000	55,000,000	7.09	6.54	4.00	3.25		
33,328,458	33,880,730	14.07	14.95	51,330,000	57,329,355	6.03	6.05	2.55	1.95		
24,402,114	21,529,968	11.29	13.25	129,236,200	84,115,800	9.43	9.52	4.25	4.25		
9,628,969	8,025,886	10.08	8.01	49,769,000	55,312,000	4.74	3.79	1.88	1.10		
\$720,269,487	\$717,783,333	11.30	12.07	\$1,638,802,378	\$1,638,518,287	\$ 6.64	\$ 6.90	--	--	\$4,946,469,407	\$4,592,826,501

SOURCE: United States Steel Corporation, Annual Report
1956.

TABLE VIII
UNITED STATES STEEL'S WEAR AND EXHAUSTION
RECORDED VS. WEAR AND EXHAUSTION NEEDED
1940-1956 TOTALS
(Millions of Dollars)

Regular depreciation	\$	1,705.7
Amortization		895.1
Accelerated depreciation		<u>201.2¹</u>
Wear and exhaustion recorded	\$	2,802.0
Wear and exhaustion needed		<u>3,706.0</u>
Deficiency	\$	<u>904.0</u>
Income taxes paid--approximately	\$	2,763.6
Income taxes paid as a result of treating the deficiency as income		608.0
Per cent of total taxes paid		22%

¹Not deductible for tax purposes.

NOTE: SOURCE: United States Steel Corporation, Annual Report,
1956.

UNITED STATES

DEPARTMENT OF THE INTERIOR

BUREAU OF LAND MANAGEMENT

WASHINGTON, D. C.

OFFICE OF THE ASSISTANT ATTORNEY GENERAL

Regular Department

Administration

Accounting Department

PROPERTY

Real Estate and Leases

REVENUE

Income Taxes

Income Taxes

Interest on Bonds

Per cent of Total

Not Subject to Tax

UNITED STATES DEPARTMENT OF THE INTERIOR
BUREAU OF LAND MANAGEMENT
WASHINGTON, D. C.

TABLE IX
EFFECTS OF FEDERAL INCOME TAX
ACCELERATED DEPRECIATION METHODS COMPARED
WITH PRICE LEVEL DEPRECIATION

Year	Asset Purchase Price	Income Before Depreciation Charge	TAX ALLOWABLE DEPRECIATION				Income Before Taxes
			60-Month Amortization	Declining Bal. Method	Straight Line	Total	
1950	\$50,000	\$ 80,000	\$ 10,000	\$ --	\$ --	\$10,000	\$ 70,000
1951		82,000	10,000	--	--	10,000	72,000
1952		84,000	10,000	--	--	10,000	74,000
1953		86,000	10,000	--	--	10,000	76,000
1954	75,000	88,000	10,000	15,000	--	25,000	63,000
1955		90,000	--	12,000	--	12,000	78,000
1956		92,000	--	9,600	--	9,600	82,400
1957		94,000	--	7,680	--	7,680	86,320
1958		96,000	--	6,144	--	6,144	89,856
1959		98,000	--	4,916	--	4,916	93,084
1960		100,000	--	--	4,915	4,915	95,085
1961		102,000	--	--	4,915	4,915	97,085
1962		104,000	--	--	4,915	4,915	99,085
1963		106,000	--	--	4,915	4,915	101,085
1964		107,000	--	--	--	--	107,000
1965		108,000	--	--	--	--	108,000
1966		110,000	--	--	--	--	110,000
1967		111,000	--	--	--	--	111,000
1968		113,000	--	--	--	--	113,000
1969		115,000	--	--	--	--	115,000
Totals \$1,966,000			\$ 50,000	\$ 55,340	\$19,660	\$125,000	\$1,841,000

NOTE: The accompanying explanations and comments are an integral part of this table.

UNITED STATES DEPARTMENT OF THE INTERIOR BUREAU OF LAND MANAGEMENT WASHINGTON, D. C. 20250

Year	Asset Purchase Price	Income Depreciation	Costs	Accumulated Depreciation	Current Value	Net Value
1950	\$20,000	\$0,000	\$0,000	\$0,000	\$20,000	\$20,000
1951		\$2,000	\$2,000	\$2,000	\$18,000	\$16,000
1952		\$2,000	\$2,000	\$4,000	\$16,000	\$12,000
1953		\$2,000	\$2,000	\$6,000	\$14,000	\$8,000
1954	\$15,000	\$2,000	\$2,000	\$8,000	\$12,000	\$4,000
1955		\$2,000	\$2,000	\$10,000	\$10,000	\$0,000
1956		\$2,000	\$2,000	\$12,000	\$8,000	\$(4,000)
1957		\$2,000	\$2,000	\$14,000	\$6,000	\$(8,000)
1958		\$2,000	\$2,000	\$16,000	\$4,000	\$(12,000)
1959		\$2,000	\$2,000	\$18,000	\$2,000	\$(16,000)
1960		\$2,000	\$2,000	\$20,000	\$0,000	\$(20,000)
1961		\$2,000	\$2,000	\$22,000	\$(2,000)	\$(22,000)
1962		\$2,000	\$2,000	\$24,000	\$(4,000)	\$(24,000)
1963		\$2,000	\$2,000	\$26,000	\$(6,000)	\$(26,000)
1964		\$2,000	\$2,000	\$28,000	\$(8,000)	\$(28,000)
1965		\$2,000	\$2,000	\$30,000	\$(10,000)	\$(30,000)
1966		\$2,000	\$2,000	\$32,000	\$(12,000)	\$(32,000)
1967		\$2,000	\$2,000	\$34,000	\$(14,000)	\$(34,000)
1968		\$2,000	\$2,000	\$36,000	\$(16,000)	\$(36,000)
1969		\$2,000	\$2,000	\$38,000	\$(18,000)	\$(38,000)
1970		\$2,000	\$2,000	\$40,000	\$(20,000)	\$(40,000)

Totals \$1,968,000 \$0,000 \$0,000 \$40,000 \$0,000 \$0,000

NOTE: The accompanying explanation and schedule are an integral part of this table.

TAX ALLOWABLE DEPRECIATION

Corporation	Income
Federal	After
Income Tax	Tax

PRICE LEVEL DEPRECIATION

Price	Price Level	Income	Income
Index	Depreciation	Before	After
		Taxes	Income Tax

\$ 30,900	\$ 39,100	102.8	\$ 2,500	\$ 77,500	\$ 34,800	\$ 42,700
31,940	40,060	111.0	2,699	79,301	35,737	43,564
32,980	41,020	113.5	2,760	81,240	36,745	44,495
34,020	41,980	114.4	2,782	83,218	37,773	45,445
27,260	35,740	114.8	10,291	77,709	34,909	42,800
35,060	42,940	114.5	10,264	79,736	35,963	43,773
37,348	45,052	116.2	10,417	81,583	36,923	44,660
39,386	46,934	120.0	10,758	83,242	36,885	46,357
41,225	48,631	124.0	11,117	84,883	38,639	46,244
42,904	50,180	128.0	11,475	86,525	39,483	47,042
43,944	51,141	132.0	11,834	88,166	39,986	48,180
44,984	52,101	136.0	12,192	89,808	41,200	48,608
46,024	53,061	140.0	12,550	91,450	42,054	49,396
47,064	54,021	144.0	12,908	93,092	43,908	49,184
50,140	56,860	148.0	3,599	103,401	48,268	55,133
50,660	57,340	150.0	3,648	104,352	48,763	55,589
51,700	58,300	152.0	3,696	106,304	49,778	56,526
52,220	58,780	152.0	3,696	107,304	50,298	57,006
53,260	59,740	156.0	3,794	109,206	51,287	57,919
54,300	60,700	160.0	3,891	111,109	52,277	58,832

\$847,319 \$993,681

\$146,871 \$1,819,129 \$835,676 \$983,453

EXPLANATIONS AND COMMENTS
REGARDING TABLE IX,
EFFECTS OF FEDERAL INCOME TAX

Assumptions made in preparation of Table IX:

1. The hypothetical company is successful and as a result reports increasing income.
2. The asset purchased in 1950 was covered by a Certificate of Necessity which permitted the purchase price to be amortized over a sixty-month period.
3. The asset purchased in 1954 was depreciated for tax purposes on the Declining-Balance Method at a rate 200% of the straight line rate. A switch to the straight line method was made in 1960 to maximize the tax deduction.
4. Federal income tax laws of 1956 were applicable to all years from 1950-1969.
5. The price indices from 1950-1956 were the Consumer Price Indices per Table I. An inflationary trend was assumed for the period 1957-1965; 1966 and 1967 were assumed to be stable; 1968 continued the inflationary trend through the final year of the example.

Explanations Applicable to Table IX:

1. Relatively long lives were selected for the assets in the example. The asset purchased in 1950 was assumed to have a twenty-year life; a ten-year life was selected for the 1954 asset. These assets were assumed to have no salvage value. The years illustrated in the table compose the years of productive service of the selected assets.
2. The two assets selected are only a part of the long-term assets of the hypothetical company.
3. The discount factor of the funds retained by using the accelerated depreciation method, as compared with price level depreciation, was disregarded for purposes of this study.

1. The first part of the report is a general statement of the purpose and scope of the study. It is followed by a brief review of the literature on the subject.

2. The second part of the report is a description of the methods used in the study. This includes a description of the subjects, the materials, and the procedures.

3. The third part of the report is a presentation of the results of the study. This is followed by a discussion of the results and their implications.

4. The fourth part of the report is a conclusion. This is followed by a list of references.

5. The fifth part of the report is an appendix. This contains the raw data and the calculations used in the study.

6. The sixth part of the report is a bibliography. This contains a list of the books and articles cited in the report.

7. The seventh part of the report is a list of figures. This contains a list of the figures included in the report.

8. The eighth part of the report is a list of tables. This contains a list of the tables included in the report.

9. The ninth part of the report is a list of abbreviations. This contains a list of the abbreviations used in the report.

10. The tenth part of the report is a list of symbols. This contains a list of the symbols used in the report.

Comments pertaining to Table IX:

1. Table IX reveals the accelerated method of depreciation allowed for tax purposes do not accomplish the same result as price level depreciation in regard to total depreciation charges recouped from income and the income tax applicable thereto.
2. A conservative approach was maintained by the writer when constructing this table in order to emphasize the importance of price level depreciation under a conservative estimate of an inflationary trend. Probable factors which would increase the difference between price level depreciation and accelerated depreciation methods in an inflationary trend include:
 - a. An increasing tax rate.
 - b. A more rapid rate of inflation.
 - c. Many assets purchased at lower point on the price level scale, depreciated on an accelerated method, and remain in service through periods high on the price level scale.
3. The aforementioned factors would increase the difference between the following significant data:

	<u>Accelerated Depreciation</u>	<u>Price Level Depreciation</u>
Depreciation 1950-1969	\$ 125,000	\$ 146,871
Federal income tax paid during 1950-1969	\$ 847,319	\$ 835,676

1. The first section of the draft is devoted to the general principles of the law. It is a very good introduction to the subject and should be retained in its present form.

2. The second section of the draft is devoted to the definition of the terms used in the law. It is a very good introduction to the subject and should be retained in its present form.

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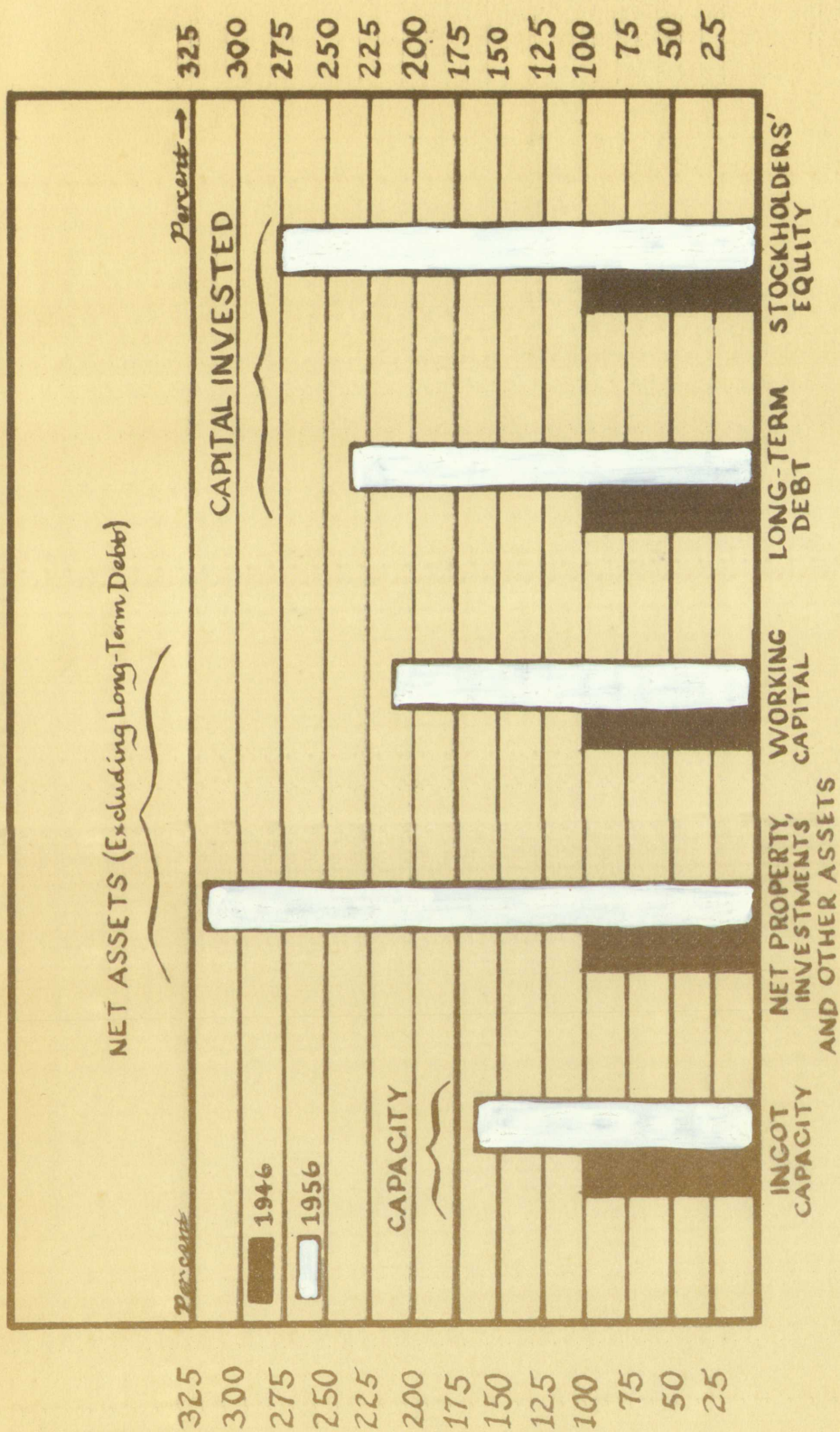


FIGURE I

INLAND STEEL COMPANY'S FUNDS INVESTED COMPARED TO CAPACITY

SOURCE: Inland Steel Company, Annual Report, 1956.



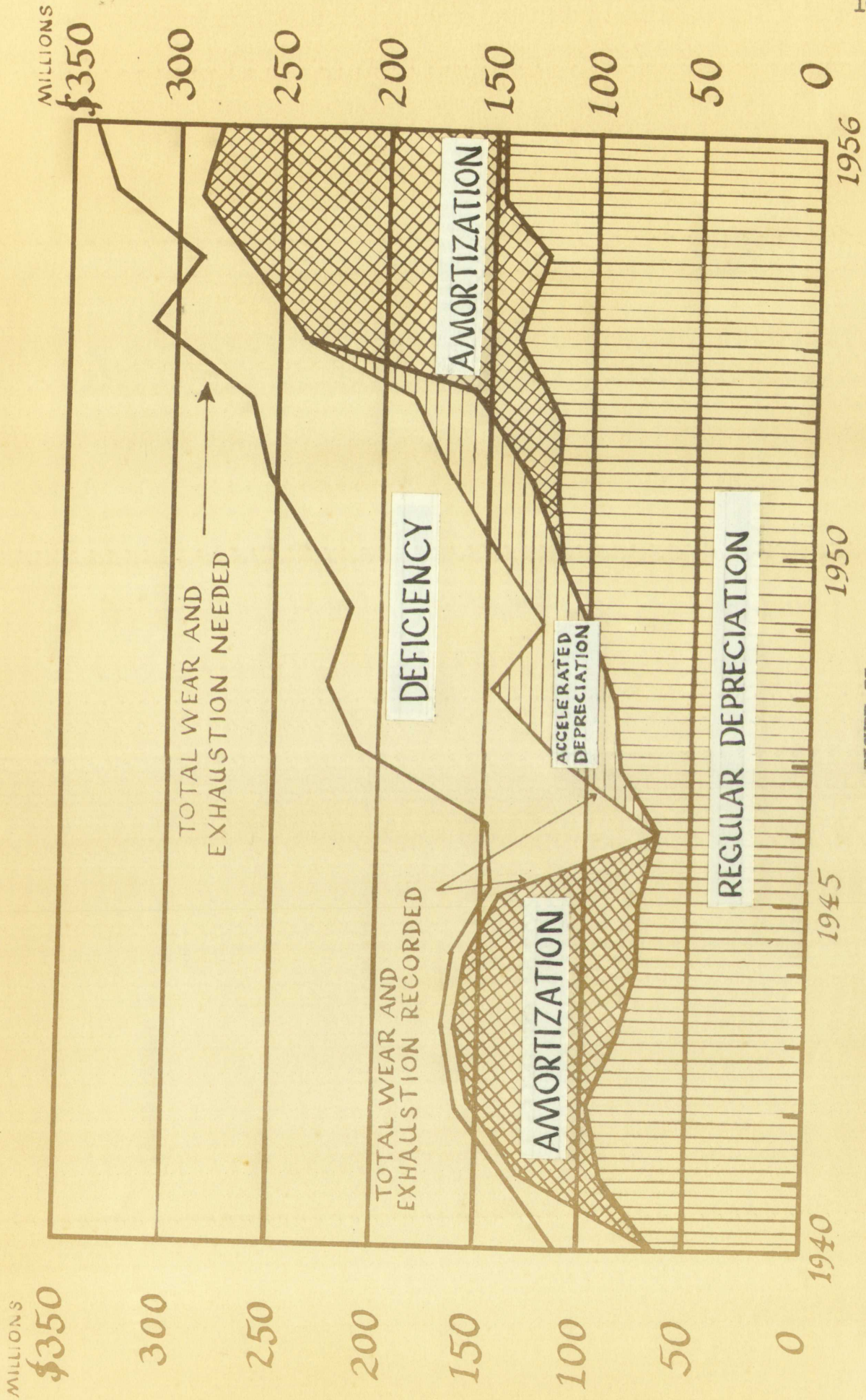


FIGURE II

UNITED STATES STEEL'S DEPRECIATION DEFICIENCY

SOURCE: United States Steel Corporation, Annual Report, 1956.

NOTE REGARDING FIGURE II

Recorded wear and exhaustion (exclusive of accelerated depreciation and including only regular depreciation on amortizable facilities) for a given year was subdivided by the prior years in which the investments being depreciated were acquired. Each subdivision was then adjusted by the change in buying power of the dollar experienced from the year of acquisition to the year as indicated by the Engineering News Record index of construction cost. Summation of the adjusted items then gave the wear and exhaustion needed to recover the proper proportion of buying power originally expended. This same process was repeated for each year, thus providing the data of wear and exhaustion needed.

In interpreting the wear and exhaustion deficiencies that have been calculated, it should be remembered that each year's deficiency is in dollars of the buying power that prevailed in that year--not in today's dollars of diminished buying power. The \$904 million aggregate deficiency for the seventeen year period would be considerably greater if the deficiencies were converted into today's dollars.

NOT RECORDED

Recorded were not estimated facilities of various
depreciation and insurance, but in the case of the
facilities for a given year are calculated by the same
which the investment being depreciated was reported. The
division was then adjusted by the change in the
dollar experienced from the year of acquisition to the year
indicated by the Industrial Price Index of Consumer Goods.
Statistical at the end of the year, the same was estimated
needed to receive a higher percentage of the power of the
expended. This same process was repeated for each year, the
providing the data of work was extended, needed.
In interpreting the year and estimated facilities and
have been calculated, it should be remembered that each year
belonging to the Industrial Price Index of Consumer Goods in the
year-not in today's dollars of estimated being given. The
million aggregate difference for the investment was not made in
considerably greater in the case of the same year compared to today's
dollars.

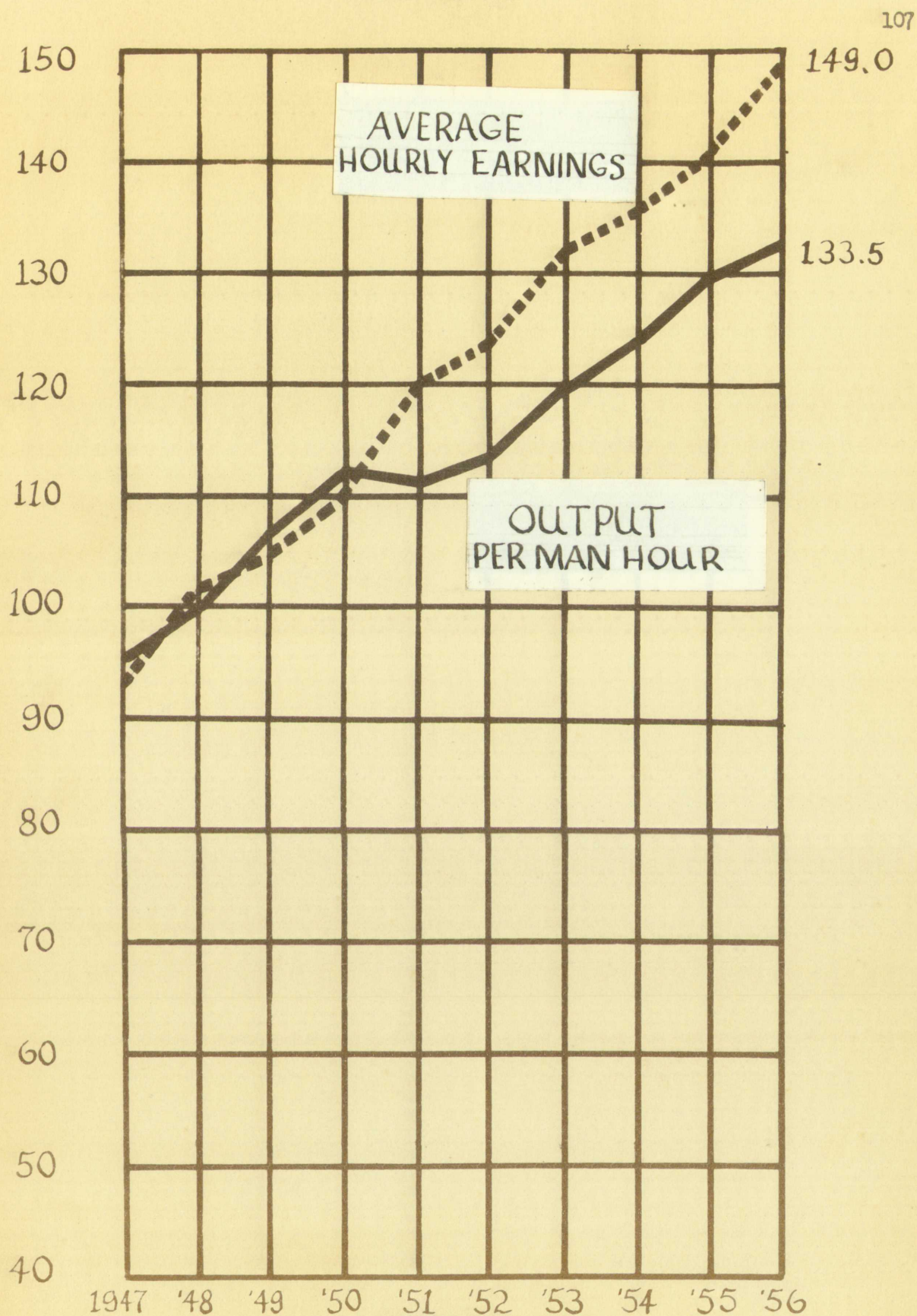
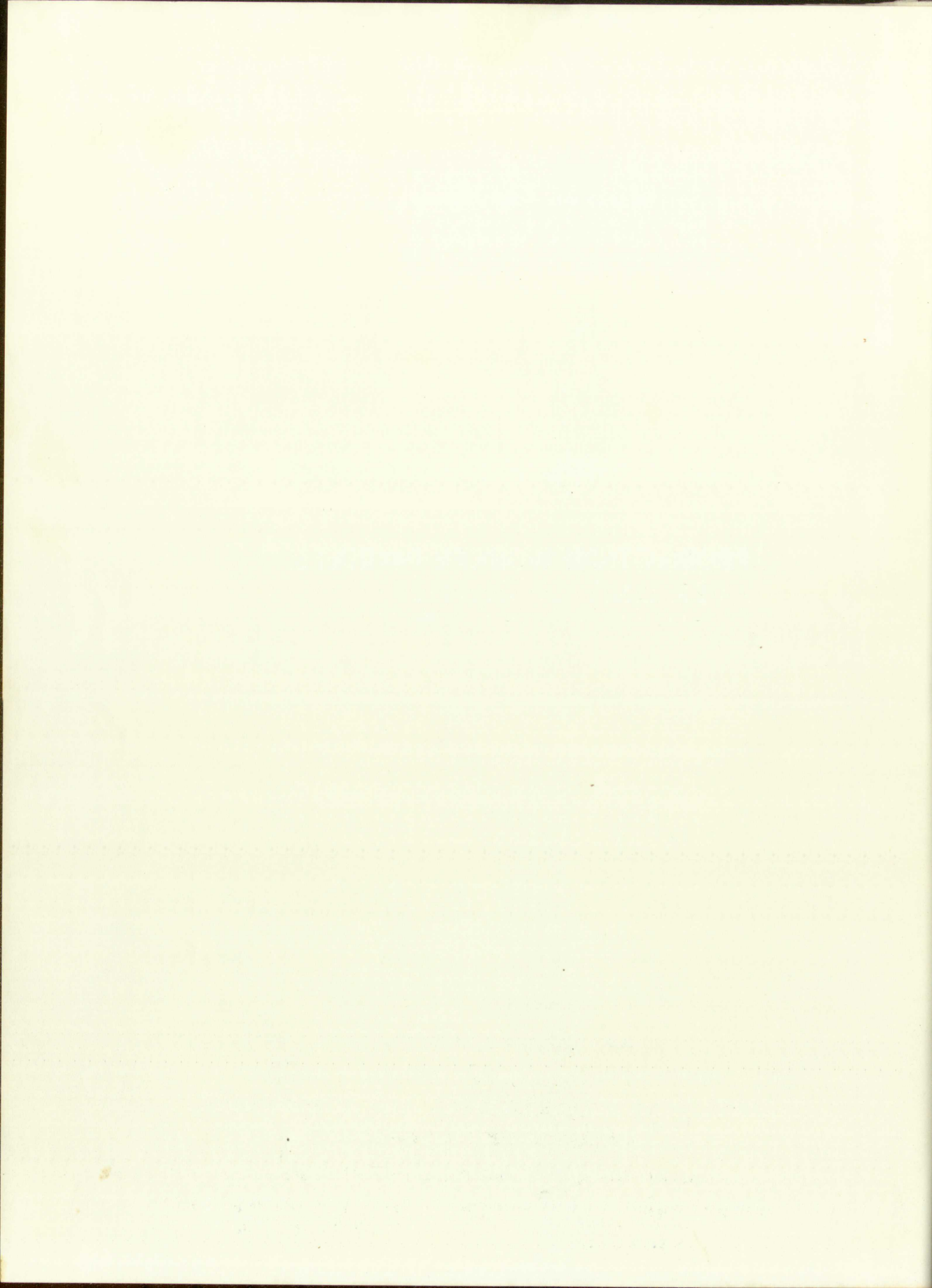


FIGURE III

PRODUCTION COMPARED WITH WAGES

Manufacturing Index Numbers 1947-1949 = 100

SOURCE: Bureau of Labor Statistics, cited in "Productivity, Prices, and Incomes," Joint Congressional Economic Committee.



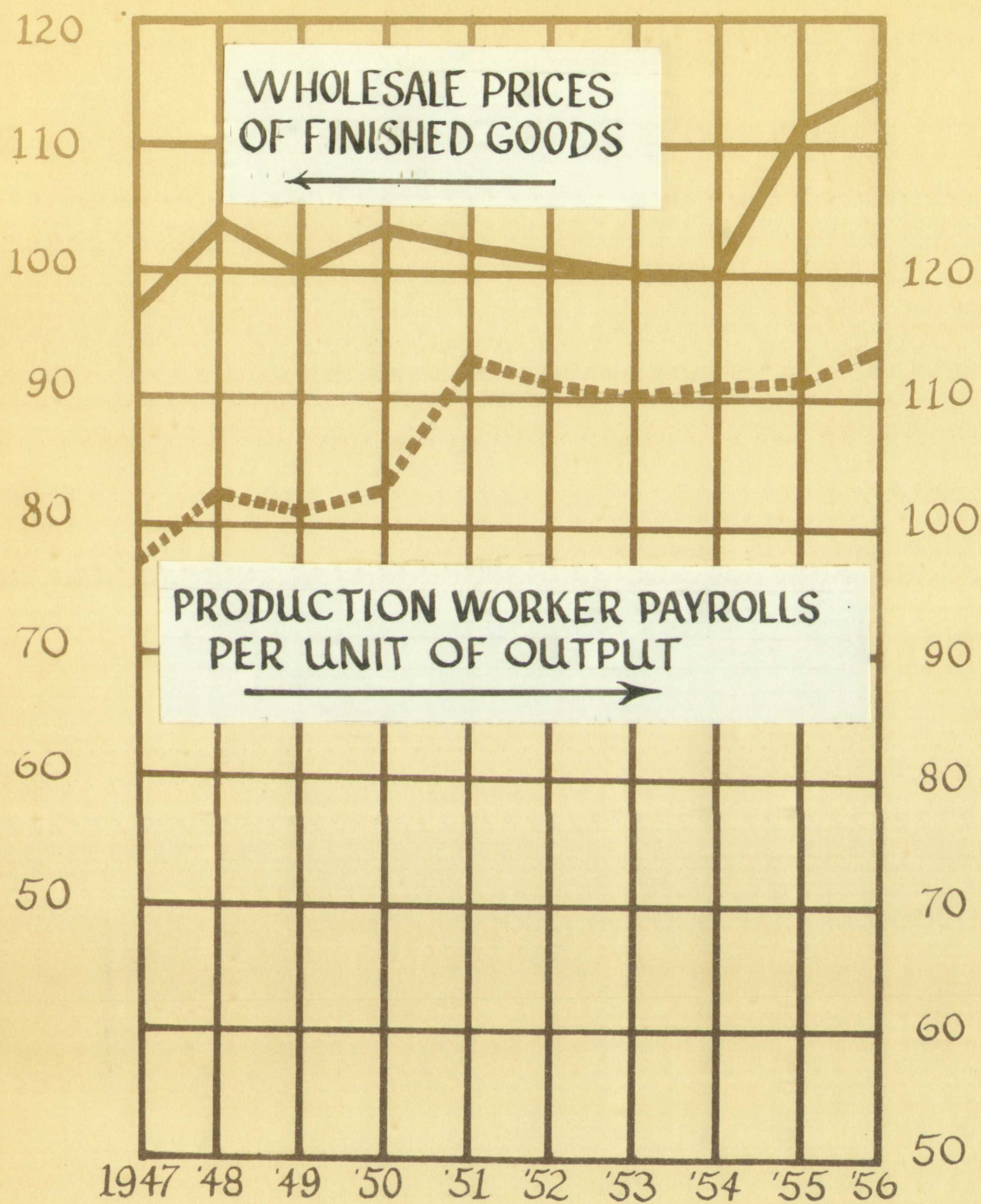
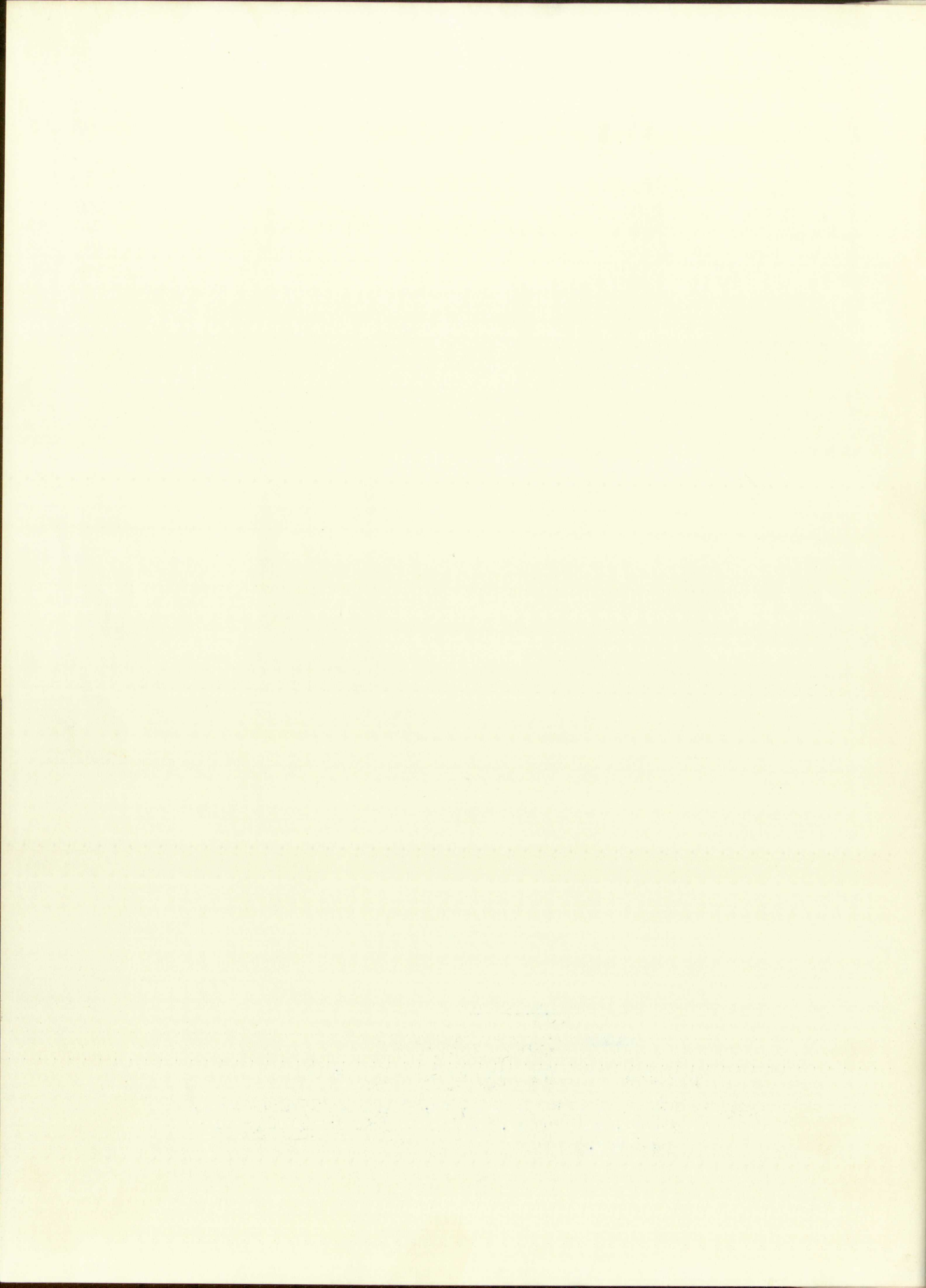


FIGURE IV

WAGES COMPARED WITH PRICES

Manufacturing Index Numbers 1947-1949 = 100

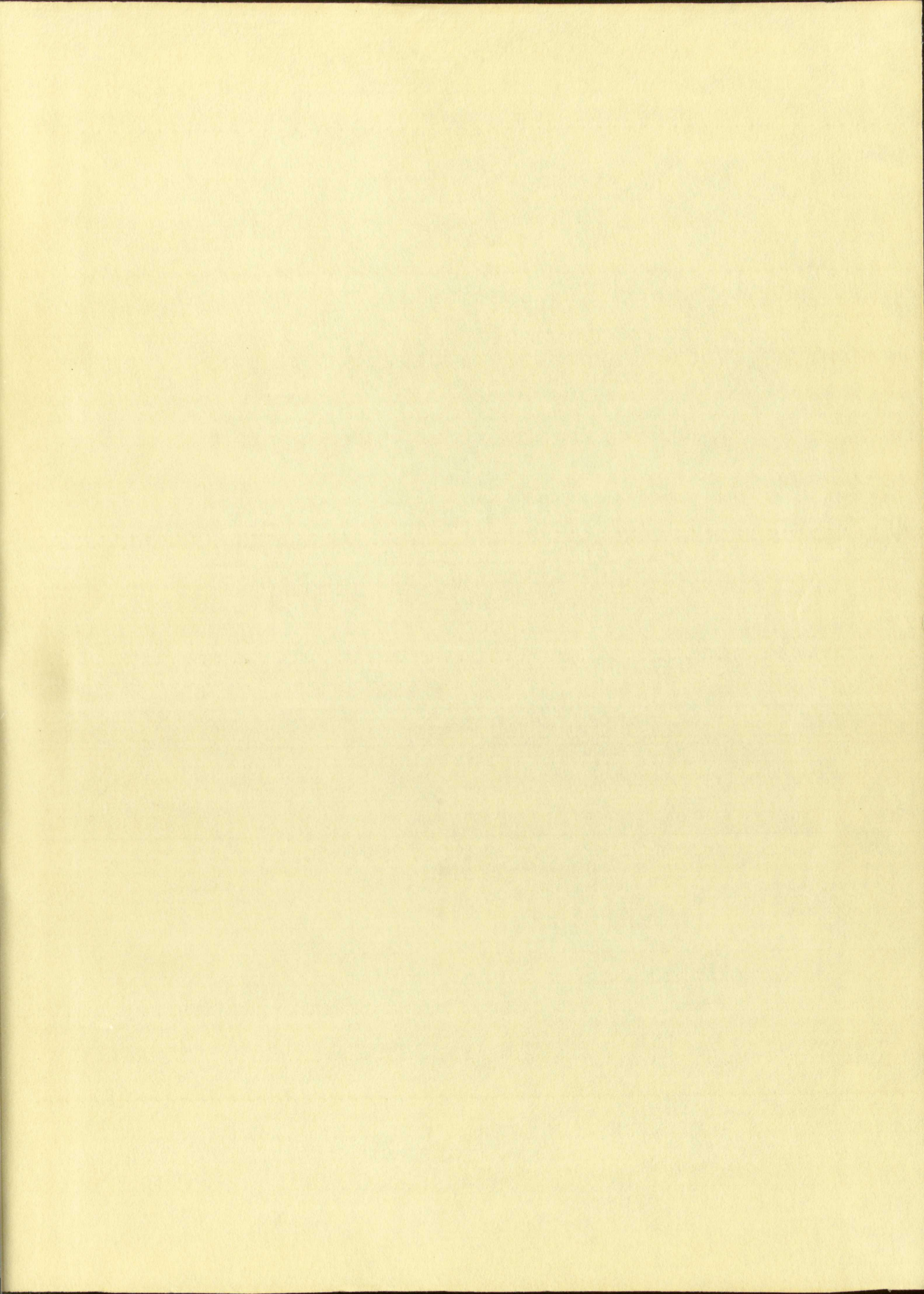
SOURCE: Bureau of Labor Statistics, cited in "Productivity, Prices, and Income," Joint Congressional Economic Committee.

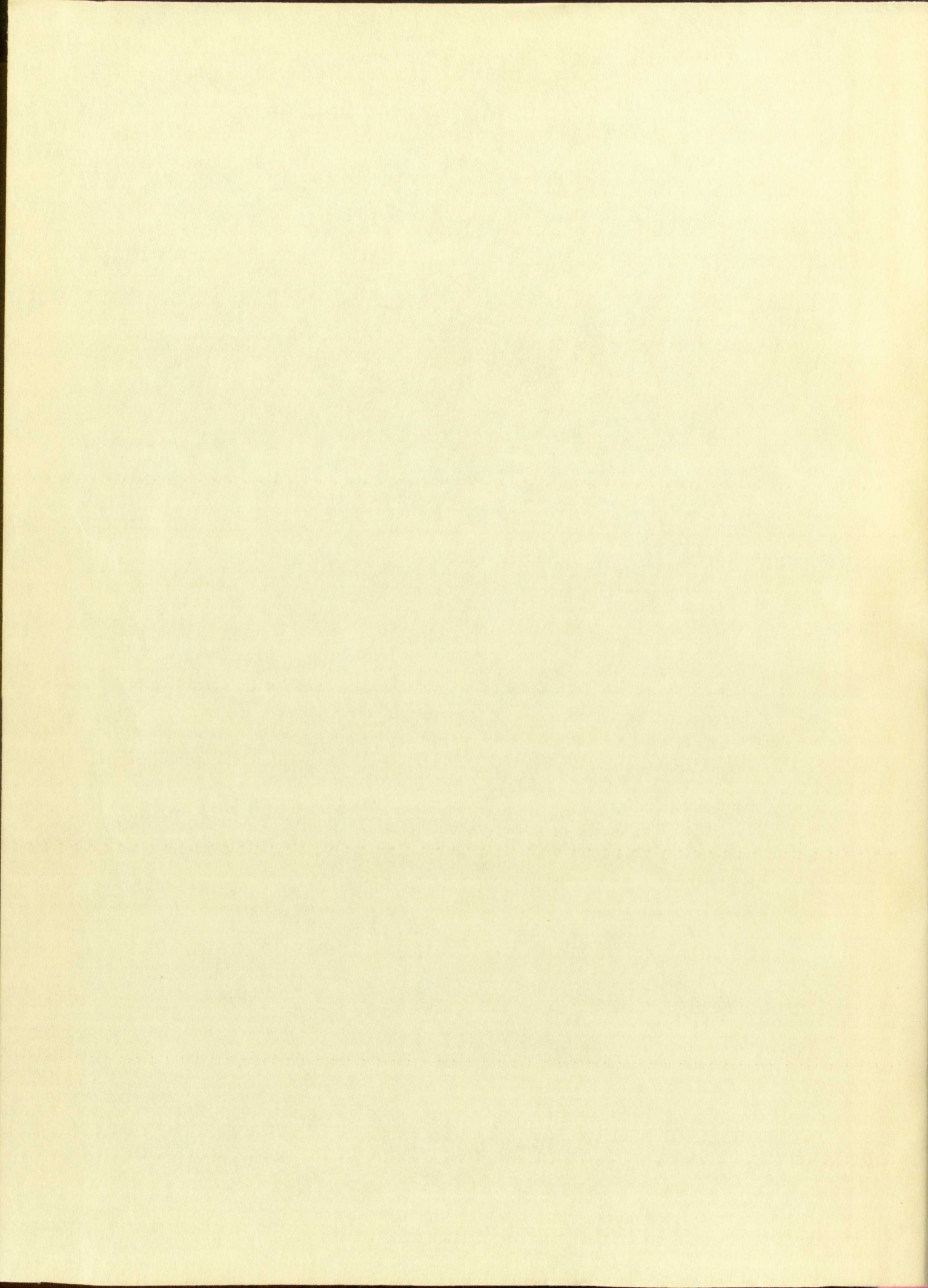


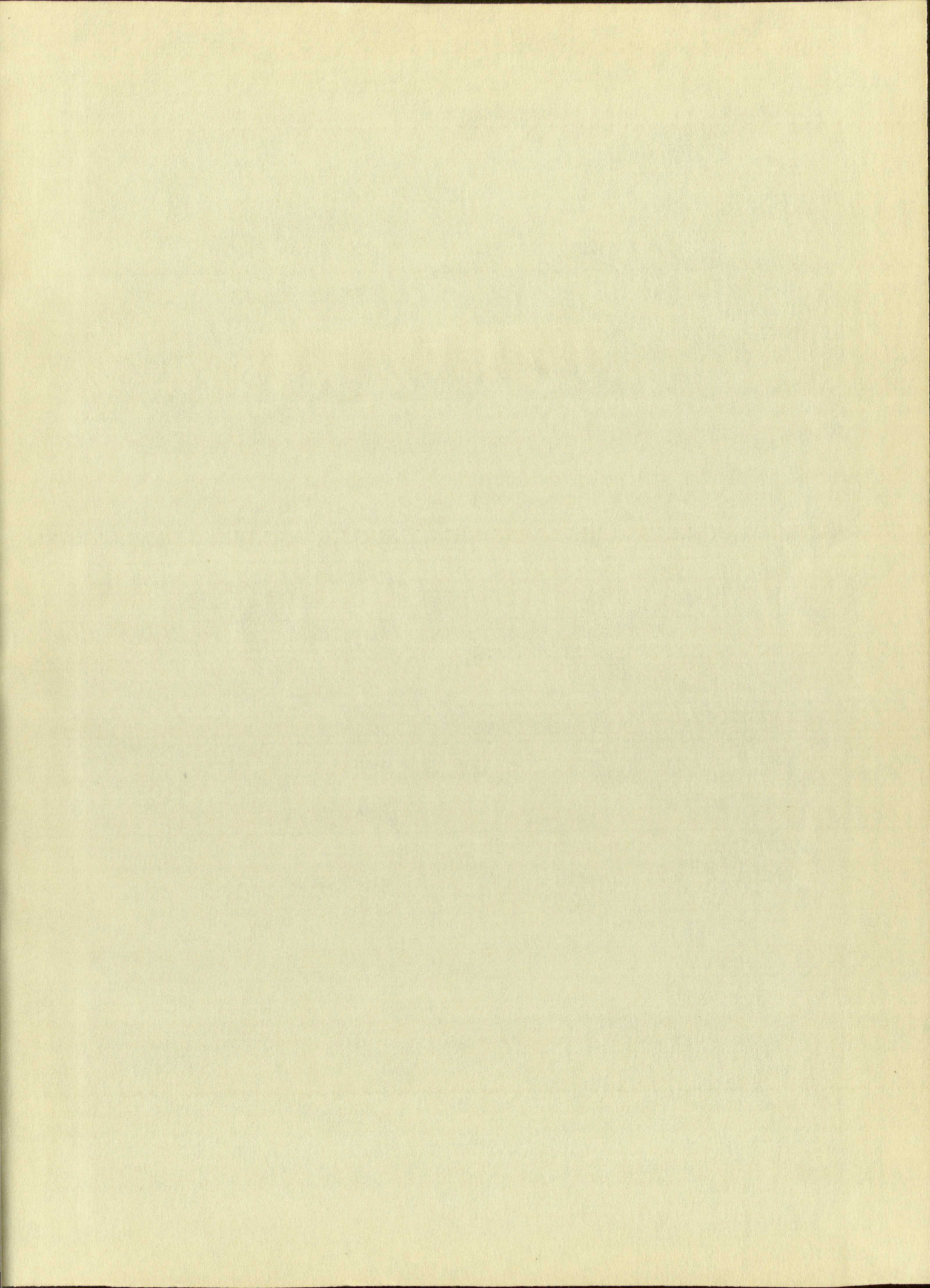
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