Studies in Inflation Accounting: A Taxonomization Approach

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There is a clear dissatisfaction today with the traditional accounting model, a system based on historical costs. This dissatisfaction stems from a phenomenon increasingly significant in the modern business environment — inflation.

The effect of inflation on the traditional accounting model and the financial statements which are produced by this model are particularly problematic, with various users of financial statements finding some inadequacy peculiar to their own needs. Managers are unhappy with the traditional model in an inflationary economy because it does not discriminate between real performance measurement and changes in the value of the measuring unit [39]. Investors are dissatisfied because the model fails to distinguish between two "identical" firms (in terms of listed dollar value of assets) whose assets were purchased in different times (with different currency values) [64]. Academicians are bothered by the lack of accurate reporting of income [55].

These accusations of inadequacy are perhaps one strong factor in recent criticism of the accounting profession. The Metcalf [58] and Moss [57] reports labeled "inflation accounting" as one form of unwanted "creative accounting"; but what is clear from these reports is the concern which legislators feel for the quality and accuracy of the representations of status and economic performance of organizations as these are presented by accountants. Legislators may not want "creative" accounting in the sense of a professional whitewash but they clearly are looking for alternative approaches to the traditional corporate model.

This study reports on a survey of more than 500 books and articles [63] that deal with the topic of "inflation accounting."[1] Even this large number is not a comprehensive survey: there are innumerable articles dealing with inflation as an economic and social phenomenon. The concern here is with accounting. From the total set of articles, some 60 were chosen, based on their timeliness, uniqueness, authority, and approach, for closer examination and classification. These 60 are deemed representative of the entire set.

purchasing power (GPP) approach which tries to show the effect of inflation on traditional financial statements by mechanistic process. This line of approach is identified by a singular measurement of historic cost and, at most, a restatement of this figure by a general price index. Adjustments to income are index-related, mechanistic in nature and reflect the effect of inflation on exposed items; (2) *Valuation based*: involving measurements of the value of assets, liabilities, income, and expenses on the basis of their stated value at a certain point in time. These approaches imply multiple assessments of value at different points of time and market conditions.

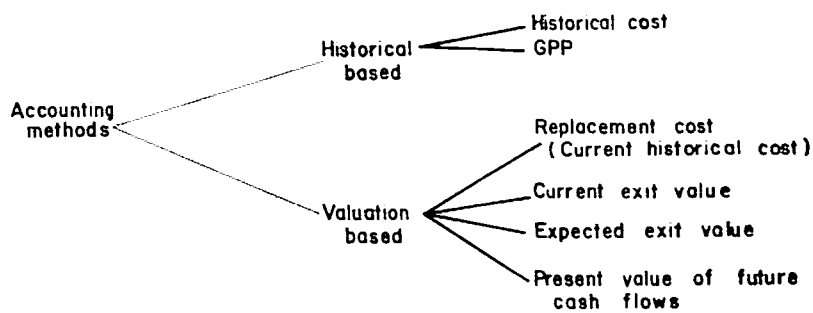
The chart displays some of the alternatives under this first taxonomy. This taxonomy focuses on one of the main issues of dispute. Historical methods are easy to implement, but, according to the critics, lack an accurate reflection of market and environmental forces. On the other hand, "value" methods are plagued by measurement and market fluctuation problems.

Two recent studies [10 and 18] surveyed the effect of the GPP method on a number of organizations. The procedure used was only an approximation of the GPP method [21] because of difficulties in the estimation of factors such as asset aging, depreciation, and other accounting procedures of the firms. Therefore, the results of the analysis can be considered somewhat unrealistic, a consequence of the mechanistic nature of the conversion process. (Criticism of the data can be found in the literature, see [56 and 52].)

The effects of "value" methods (as opposed to historical based GPP) are considerably more difficult to extrapolate from published historical data. Any attempt to measure such effects must first utilize "specific" indexes which are often characterized by large variances according to the particular asset in question. Although a mechanistic time approach may be used for the conversion of historical figures to value figures (see [37 and 62]), major assumptions must be made concerning inventory valuation methods, the relationships between the value of assets and specific indexes, and income distributions through the year.

The historical value dichotomy thus displays some interesting characteristics.

MAIN LINES OF THOUGHT CONCERNING REPORTING UNDER INFLATION



First, extrapolation of potential outcomes is simpler under the GPP method because of its simple method of adjustment. Value methods lead to much more difficult computations, but also a fuller understanding of the business in question, its asset composition, and its sales and collection patterns. Consequently, the literature presents GPP studies similar to the two analyses of the GPP method already cited, while most of the value literature is oriented toward either theoretical support of the particular value method in question or a technical description and comparison with other methods, for example, [19, 11, 25, and 46]. A noteworthy exception to this general picture is the work of McKeown [35 and 36].

This survey has found that major attention has been given to the GPP method with considerably less emphasis placed on value methods. The recent *ASR No. 190* requirement of the SEC, however, has generated a new wave of interest in replacement cost, for example, [11, 30, and 5].

The foregoing discussion leads to some conclusions. First, it is desirable to procure empirical data on value accounting methods in order to understand their implications better. This conclusion was also reached by the FASB which asked voluntary cooperation of a number of large corporations in a process of monitored experimentation. This need calls for a researcher to study specific cases, for example [19, 25, and 35], on a larger scale in order to evaluate the effects of value accounting better. Second, this dichotomy of historical versus value approximates the initial positions assumed by the FASB and SEC in adopting the GPP and replacement cost methods respectively. Such a disparity of approaches has drawn the lines of an already extensive controversy even more clearly [53, 55, and 17].

With the issue of inflation accounting in this state of confusion and uncertainty and with this abundance of effort being extended, it seems that the most immediate priority is to focus this effort to the most crucial issues. Perhaps a classification effort, such as that attempted here, will give the profession some indication as to the general areas that have attracted and will continue to attract research in the area of inflation accounting.

A TAXONOMY OF METHODS

Buckley and his coauthors [15] proposed four basic strategies in decision-making research: opinion, empirical, archival, and analytic. These categories are somewhat constraining in trying to classify inflation research. Therefore, some basic changes were made to Buckley's framework; these are displayed in Table 1. These changes encompass the aggregation of some techniques and the addition of one research strategy called "educational." This strategy is exemplified by contributions to the literature which are not entirely original but which illuminate some points or clarify a topic for a special audience. Academic educational research serves to illustrate or expand on methodologies already in use. General educational works provide a description of proposed

Table 1

METHODOLOGIES AND SELECTED STUDIES IN INFLATION ACCOUNTING RESEARCH[a]

Strategies	Techniques	Articles
Opinion	Survey of individuals or groups	The Accountant [1][b], Perrin [42], Laidler and Parkin [33], Sadowski and Nadolny [48], Brenner [13]
Empirical	Case	Enthoven [19], Goudeket [25], Russell [47], Black and Koch [11]
	Field studies	Bradford [12], McKeown [35 and 36]
	Laboratory study	Burket [16], Samuelson [49], Ibotson and Sinquefield [28], Parker [40], Davidson and Weil [18], Heintz [27]
Archival	Primary and secondary	Peterson [43], Myddelton [39], Gynther [26], Bastable and Merriwether [6], Terborgh [55], Bastable [5], Peasnell and Skenott [41]
Analytic	Internal logic (mathematical)	Peterson and Keller [44], Ijiri [29], Bierman [10], Vasarhelyi and Bao [62], Minahan and others [37], Kaplan [32], Bedford and McKeown [8], Staubus [52]
	Theory and personal opinion	Chambers [17], Sterling [53], Rosenfeld [46], Moonitz [38], and Friedman [24]
Educational	Academic	Summers and Deskins [54], Theis and Revsine [56]
	General description of methods	McCosh [34], Friedman [24]
	Management-oriented	Weston [64], Vancil [59], Vancil and Kelly [60], Rosenfield [46]

[a] Adapted from [15].
[b] News item.

inflation accounting methods. Management-oriented educational papers direct inflation accounting issues toward topics of general interest to management.

A careful analysis using this taxonomy indicates that a large part of the literature concentrates on nonempirical methods. On the other hand, history seems to indicate a trend toward more empirical research and away from procedural and dialectic articles. Examination of Table 1 and comparison with some of the literature surveyed reveals some interesting facts:

(1) Few if any multicontextual case studies can be found;
(2) Early opinion and theory articles have generally given way to empirical and model-building studies;
(3) Few field studies were found in the literature; and
(4) Analytic-internal logic articles seem to present the sounder methodologies.

two attributes, interpretability and relevance. He concluded that "... the appropriate procedure is (1) to adjust the present statement to current values, and (2) to adjust the previous statements by a price index. It is important to recognize that both adjustments are necessary and that neither is a substitute for the other" (p. 51). These conclusions are based on the fact that the "price-level-adjusted current value method" satisfies both the interpretability and relevance criteria while the historical cost method does not satisfy any and the other methods only satisfy one of the two.

Samuelson [49] utilized a "predictive ability" criterion when comparing the price-level-adjusted and the historical cost income figures of public utilities. His results were inconclusive.

> ... the effect of price-level adjustment on the predictive ability was small relative to the overall accuracy of the predictions.... While the empirical test has been inconclusive with respect to the alleged bias of unadjusted data, it has provided some evidence about the predictive ability of earnings numbers and the relative importance of price-level adjustments for predicting asset returns. (p. 343)

In rebutting Sterling's article, Chambers [17] proposed "continuously contemporary accounting," in his view the only method that "(a) deals with changes in the specific prices of assets (b) deals with the general effects of inflation on an original investment (including the effects on monetary items) and (c) secures by explicit rules that the purchasing power of an initial investment is maintained in the calculation of income" (p. 62).

Vancil [59] used a hypothetical case and oriented his discussion toward management's information needs. The two basic criteria he formulated were adequacy in measurement of operation and investment performance. His conclusions ranked specific and general price-level accounting (SPLA) superior to current replacement value accounting (CRVA), with both of these better than GAAP or GPLA (general price level accounting): "Either replacement-value method is better than the historical cost methods as a gauge of operating performance" (p. 65) and "... either GPLA or SPLA is a better method for measuring investment performance than GAAP or CRVA.... On the issue of whether or not to employ replacement value, SPLA is preferable to GPLA...." (p. 66).

These outlined comparisons show a lack of agreement in terms of terminology, criteria, and methodology of evaluation. On the other hand, there is present a desire to compromise and to recognize the possibility of picking the best of the different approaches. Unfortunately, the convergence-compromise effort has not yet manifested itself either in the literature or in the actions of the rule-setting bodies. It may be that empirical studies represent the only path to the resolution of these controversies. Thus, the movement in this direction presently occurring is timely and necessary.

SOME SELECTED EMPIRICAL STUDIES

Williams and Griffin [65] discussed the nature of empirical verification in accounting by examining the nature of the theories being verified and then proceeded to obtain initial insights through a taxonomization and summarization approach. They stated that "attempts to verify propositions about accounting are a comparatively recent theoretical and empirical exercise . . . Indeed, most of the examples are dated within the last five years" (p. 154).

Table 3 displays a set of some 11 selected empirical studies in the area of inflation accounting. All these studies were performed within the last 10 years, with the greater frequency in the most recent years.

Some of the earlier studies [49 and 35] dealt with the predictive ability of GPP numbers and the feasibility of the Chambers model respectively. The most recent studies deal with analyses of published financial data, potential adjustments to these data, and the materiality of the adjustments' effects.

Unfortunately, in-depth analyses of field situations, user perception of value data, and exeprimentation with firms are not widely available in the literature. Two studies in progress [9 and 61] deal with the problems of user perception and preference of value data using, respectively, a survey and laboratory approach. Studies such as these have considerable potential but also present problems with subject bias because of professional occupation and education.

In addition to the two basic taxonomies presented, a number of other approaches for the classification of inflation accounting studies could be used. We shall next propose some of those available to future researchers.

OTHER POTENTIAL TAXONOMIES

One classification of published work in inflation accounting might place emphasis on the various problems that confront different audiences. Table 4 displays such a taxonomy along with the particular objectives of the different groups. This treatment could pinpoint the potential issues and conflicts of objectives among users and could also serve to distinguish between valid argument and self-benefiting lobbying.

Another classification of interest to researchers might be a taxonomy based on very general lines of discussion, as shown in Table 5. Many different approaches have been advocated (and adopted in various countries) in the articles concerning the best way to present inflation accounting data. The British (that is, the Sandilands report, see [34]) opted for current value accounting expressed in the main body of financial statements. The FASB has proposed supplemental GPP information. The SEC (*ASR No. 190*) required replacement cost disclosure in the form of a note accompanying Form 10-K filed with the SEC with a cross-reference in financial statements. Ijiri [29] discussed a dual presentation method which would disclose historical cost side by side with GPP adjusted data. Clearly, no consensus has been reached

Table 3

SOME SELECTED EMPIRICAL STUDIES

Author	Research objectives		Scope and method of analysis	Conclusions	
	Purpose	Basic propositions		Answer to basic proposition	Some generalizations
Bautable [5][a]	Evaluate the value of replacement cost disclosures	Replacement cost data is not worth the effort	Empirical, 20 companies examination of public disclosure	Author considers the data not to be cost effective	A more careful rule formulation process is needed
Bradford [12][a]	Evaluate the use of inflation gains and losses in GPP		Model building and application to published data of 11 large firms	Present methodology is inadequate as it ignores anticipated inflation and different returns on monetary items	Adjustments for gains and losses should be performed but correctly calculated
Brenner [13][a]	Evaluation of user perception of current cost information	Current cost information would be helpful	Empirical, 241 questionnaires to bankers, stockholders, and analysts	Information would be useful	Current cost information should not replace historical information
Davidson and Weil [18][a]	Evaluate the effect of GPP adjustments		Empirical, 101 companies (total), shortest estimation method		Effects of GPP adjustments are substantial, vary considerably among sectors particularly the effects of gains-losses in monetary assets
Heintz [27][a]	To determine the effect of price-level restatement on decision-making	GPP accounting will change into investor forecasts	Laboratory experiments with graduate students, real company data, decisions in 3-8 periods	No forecast differences perceived	
McKeown [35][a]	Empirical testing of Chambers Model	Chambers Model may be applied to a real life situation	Field study of feasibility of the model on a medium sized company	The model is feasible and more reliable than conventional financial statements	Additional field studies suggested

relating current account valuation to current operating results, proposals have been made recommending the elimination of comparable balance sheet and income statements. Such proposals may lead to the use of different valuation bases in the same "set" of financial statements. The asset/liability classification includes studies which emphasize the valuation of financial statement items while the typical revenue/expense study emphasizes the principle of matching costs and revenue. The difficulties of harmonizing these two approaches are so considerable that, in recent discussions of the Committee of Corporate Reporting of the Financial Executive Institute, an unarticulated approach has been proposed and found desirable. This approach would allow both methods to be adopted, one for each of the two major financial statements. The lack of consensus on this issue has led to the argument advanced by some corporate executives that all desirable accounting information related to the effects of inflation could be informally disclosed in the nonaudited sections of financial statements. Finally, the decision between emphasis on the maintenance of the physical capital (productive capacity) and the financial capital is an important issue.

The last criterion presented in Table 5 invites discussion based on a measurement method taxonomy. Practitioners and corporate executives have been concerned with questions of inflation accounting implementation; the measurement method is fundamental to this issue. Measurement has also been used as a criterion for approach selection [53, 45, and 29].

Tables 4 and 5 present several alternative taxonomies that have not been extensively explored in this article. They provide a very prolific source for future research and represent a feasible approach for convergence in inflation accounting ideas.

CONCLUSIONS

In this article we have surveyed inflation accounting literature with emphasis on the alternative accounting philosophies advocated, resulting in a selected listing of articles and books dealing with the inflation accounting problem. This listing does not exhaust the literature in the field but is representative. This subset of the literature was carefully surveyed and abstracted, leading to a number of conclusions concerning the state-of-the-art, trends of thought, and paths for future research.

The history of inflation accounting study is characterized by a long-range interest in the topic and a recent surge of discussion inspired by widespread international inflation. The literature is heterogeneous and presents no agreement concerning the optimal method; nevertheless, one can trace an increasing awareness of problems and their potential solutions. Articles calling attention to the inflation problem were the first step of the recent cycle. The second phase was characterized by a series of "how-to-do-it" articles concerning the

different methods, and a larger set of personal opinion articles by well-known scholars and practitioners on the relative merits of the alternative methods. The third and current phase is characterized by the desire for compromise evident in scholarly literature, and a set of definitive rules established in several countries, providing implementation guidelines for the methods adopted. The fourth phase will reveal sounder research methodologies which apply mathematical models, simulations, and, to a lesser extent, case studies to the inflation accounting problem.

The trends in the literature are toward studies more substantive in methodology; evaluations of the impact of inflation by business organizations, special interest groups, and government agencies; and the design and implementation, through negotiation, political pressure, and academic input, of inflation accounting procedures.

The paths for future research are many. First, the taxonomies introduced in this article are a sound starting point for the comprehension of the difficulties found in inflation accounting. Second, there is open field for research in the analysis of the implications and outcomes of the replacement cost disclosure in the US and of current cost accounting in the United Kingdom. This research can be performed at low cost and will provide the case studies that are needed for the evaluation of value-based methods. Third, a set of criteria for the evaluation of inflation accounting alternatives is necessary. This paper has presented some suggested criteria such as relevance, interpretability, income-predictive ability, and measurement quality vis-à-vis operating performance and investment performance. To these could be added others: uniqueness of treatment across industries, macroeconomic and sociological impact, implementability, costs of data processing, consistency, and reproducibility. All these criteria must be carefully evaluated.

A fourth research possibility would explore the definitions and notations for establishing a framework for a conceptual and implementation compromise. The base lines of this effort have been drawn by the FASB through its discussion memorandum on the "conceptual framework," and some specific compromises such as its rulings on leases and restructuring of debt. A fifth research path exists in the accounting subarea of human information processing. Without a better comprehension of how audiences perceive and use information, no resolution can be brought to the central issues. These issues also need inputs from "efficient market" research concerning information utilization and collective impact analysis. The sixth area of potential research calls for more creative approaches in inflation research, such as laboratory studies (not only restatement simulations); macroeconomic impact analyses (with methodologies other than Terborgh's [55]); archival research into the aging, retirement, and taxation of plant assets; utilization of participant observation methodologies, and others used in the social sciences. Last, interdisciplinary work is potentially valuable. Vancil [59] states that "as some decisions in war are too important to

be left to the generals, so this decision concerning the inflation controversy is too important to be left to the accountants" (p. 59). Increasingly the literature acknowledges the social implications of accounting rules; the need for integration of accounting research findings into the fields of economics, law, and the social sciences must also be acknowledged.

Given the far-reaching implications of inflation accounting and the costs and benefits associated with the resolution of the problem, the 500 works surveyed can be considered only a beginning. More research, perhaps directed in the seven areas previously mentioned, may well be the next step in the inflation accounting effort.

NOTES

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1. The two bracketed numbers at the end of each reference are related respectively to the article's classification within the schemata presented in Tables 1 and 2. Non-bracketed references are of a general nature.

Schema of Table 1	*Number*
Opinion	1
Empirical — Case	2a
— Field	2b
— Laboratory	2c
Archival	3
Analytic — Mathematical	4a
— Theory	4b
Educational — Academic	5a
— General description	5b
— Management	5c

Schema of Table 2	*Number*
Historical based methods	I
Valuation based methods	II
Both	III
Not applicable	NA

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