THE SEC AND REPLACEMENT COST ACCOUNTING:
IMPLICATIONS FOR FINANCIAL REPORTING
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The recent decision of the Securities and Exchange Commission (SEC) to require disclosure of replacement costs, albeit only for companies above a certain size, is a first step toward disclosure of information that may be less objective and verifiable than has been and is presently true. Because of the pervasive impact of positions taken by the SEC on both Canadian and United States firms, this series release will impact significantly on financial reporting. Interestingly, the Chief Accountant of the SEC feels that the policy implications of ASR 190 are likely to be quite significant. However, much remains to be evaluated regarding both the theoretical and practical aspects of this release. In addition, the release will undoubtedly impact on policy positions taken in the future by both the Accounting Research Committee (ARC) and the Financial Accounting Standards Board (FASB). It will be the purpose of this paper to briefly review the genesis and current status of the CICA, AICPA, FASB and SEC on the central measurement and disclosure issues which are at the heart of ASR 190. We will also make a modest attempt to discuss short and long range theoretical and practical implications of the current policy situation.

In order to achieve the goals identified above, we will describe the existent Canadian, American, and SEC positions on inflation and current value accounting. ASR 190 will be outlined and its more significant aspects will be explained. Finally, implications, as perceived by the authors, for financial accounting, on both sides of the border, will be discussed in the context of the future direction of public reporting both in the short and in the longer term.

A BRIEF HISTORY OF DEVELOPMENTS WITHIN THE CICA

Professor L. S. Rosen, in the study he completed in 1972 for the CICA entitled Current-Value Accounting and Price-Level Restatements, suggested a
need for several methods of valuation in addition to historic cost. Further, he states "The **reporting** of price-level restated historic costs of **assets** and **liabilities** (liabilities excludes "owner's equity") to recognize fluctuations in the exchange value of the dollar, appears to have limited benefit for internal and external readers of financial statements. ...Hence it is urged that the Research Committee of the Canadian Institute of Chartered Accountants **not** pursue this avenue in future research and pronouncements on the subject."^3 (Emphasis in the original). Rosen proposed that further research is needed before any conclusions can be reached as to a method for reflecting the impact of inflation.

In December, 1974, the ARC issued an Accounting Guideline entitled "Accounting for the Effects of Changes in the Purchasing Power of Money." Its purpose was to suggest a procedure for translating historical cost financial statements "to assist an enterprise which decides that this additional information will enhance the usefulness of its financial reports."^4 The approach suggested was **general price-level accounting**. The guideline does not have the force of a recommendation—it is merely a suggestion. The ARC does indicate that the guideline reflects its thinking on the subject of inflation accounting at the date of issue.^5 Interestingly, current value accounting is rejected because "a number of issues and practical matters would have to settled before current value system could become part of generally accepted accounting principles."^6

In July, 1975, the ARC issued an exposure draft dealing with accounting for changes in the general purchasing power of money.^7 In the introduction, the Committee noted the need for providing information to readers of financial statements to help them overcome the limitations of historical cost financial statements resulting from rapid changes in the value of the dollar. They suggest that either price-level restated or current value (i.e. replacement cost) information would partially alleviate the problem and stressed that their choice of the former does not preclude them from "considering current value accounting, either as
a replacement for general price-level accounting or in combination therewith.\textsuperscript{8} However, the Committee's decision was to elect general price-level accounting as a first step toward providing readers of financial statements with more information.

In October, 1975, the ARC decided to also pursue current value accounting and approved the preparation of a discussion paper on that topic.\textsuperscript{9} To date the discussion paper has not been released.

\textbf{A BRIEF HISTORY OF DEVELOPMENTS WITHIN THE AICPA AND FASB}

The American Institute of Certified Public Accountants, through its research activities and through the policy making activities of its now dis-established Accounting Principles Board (APB), has been active in attempting to develop a basis for policy making in the price-level area for some time. The first major effort directed toward achieving a better understanding of the principles and measurement problems inherent in the general price-level restatement process (GPLR) was a research report prepared by the research staff of the AICPA entitled "Reporting the Effects of Price-Level Changes."\textsuperscript{10} This report contains detailed discussions of the various issues underlying the GPLR process and an excellent discussion of problems associated with index number derivation and use by Cecelia Tierney.\textsuperscript{11}

Next, the AICPA sponsored a feasibility evaluation of GPLR the results of which were reported in a 1969 paper by Rosenfield.\textsuperscript{12} Generally, the findings indicated that GPLR was achievable by the test group of companies, but that some systems revision cost would be incurred if reporting on this basis became a regular requirement. At about this same time, the APB issued its statement Number 3 entitled "Financial Statements Restated For General Price-Level Changes."\textsuperscript{13} This statement made clear the Board's view regarding the correct procedure
underlying the GPLR process but concluded, that "... the degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance ...," and further "Although ... this conclusion is obvious with respect to some countries, it has not determined the degree of inflation or deflation at which general price-level statements clearly become more meaningful." 14 This statement made clear that GPLR statements were voluntary.

Through the demise of the APB and the establishment of a similar policy making body, the FASB, the problem remained of major concern in the United States. Impetus to this concern was in part added by the pervasive increase in the general price-level experienced during the 1970s and in part because of major attention being given to the GPLR alternative in England. 15 In 1974, the FASB, in an attempt to come specifically to grips with the problem issued a Discussion Memorandum entitled "Reporting the Effects of General Price-Level Changes in Financial Statements." In December of 1974, after receiving extensive comments on the issues involved, the FASB issued an Exposure Draft on the subject which was to become effective as a Financial Accounting Standard on January 1, 1976. 16

As a minimum, the proposed standard required disclosure of potential GPLR information as follows:

1. With respect to each period for which an income statement is presented:
   a) Total revenue
   b) Depreciation of property, plant, and equipment
   c) Net general purchasing power gain or loss
   d) Income from continuing operations
   e) Net income
   f) Net income per common share
   g) Cash dividends per common share.
2. With respect to each date for which a balance sheet is presented:
   a) Inventories
   b) Working capital
   c) Total property, plant, and equipment, net of accumulated depreciation
   d) Total assets
   e) Total common stockholders' equity.

In November of 1975 the FASB announced that a final statement on GPLR would be forthcoming in 1975, obviously precluding the planned effective date of January 1, 1976. The Board invited interested organizations to experiment extensively with gathering data on the proposed new basis. In addition, the Board conducted field tests in GPLR impacts with eighty-four test companies and also gathered data on the impact of test results on twenty companies of the American Petroleum Institutes. The Board received extensive comment on the proposed reporting during this period and announced in June, 1976, that it had decided to defer further consideration of the GPLR reporting standard. In making this decision, the Board stated "... that general purchasing power information is not sufficiently well understood by preparers and users and the need for it is now sufficiently well demonstrated to justify imposing the cost of implementation upon all preparers of financial statements at this time." The Board explained this decision in part by commenting that "The current effort being undertaken by the largest corporations to provide the current replacement cost to required by SEC Accounting Series Release No. 190 and the further consideration at will necessarily be given to financial measure in units of general purchasing power in connection with the Board's conceptual framework project were important factors in deferring further consideration rather than attempting to reach a final agreement at this time." (Emphasis added)
Therefore, the current position of the FASB on the GPLR issue seems one of deferral in favor of the forthcoming conceptual framework study.20

A SUMMARY OF THE SEC POSITION

In August, 1975, the SEC proposed amendments to Regulation S-X that "would require footnote disclosure of certain financial data regarding current replacement cost."21 It is interesting to note that this proposal was issued at the height of the debate and discussion of GPLR by the FASB and its' constituency. Subsequently, on March 23, 1976, the SEC issued ASR 190 which was to "enable investors to obtain more relevant information about the current economics of a business enterprise in an inflationary economy than that provided solely by financial statements prepared on the basis of historical costs."22 This new ASR required all companies registered with the SEC which reported inventories and gross fixed assets (excluding land) totaling more than $100 million and amounting to more than 10% of total assets to disclose:

1. The current cost of replacing inventories
2. The current cost of replacing productive capacity
3. Cost of sales as if it had been computed using replacement costs
4. Depreciation as if it had been computed using replacement costs.

The disclosures will be required for all affected companies with fiscal years ending on or after December 25, 1976.

The SEC simultaneously released a Staff Accounting Bulletin interpreting ASR 19023 and an amendment to Regulation S-X which proposed a "safe harbor" for those companies who provided the necessary replacement cost data provided that the information "(1) had been prepared with reasonable care, (2) had a reasonable factual basis and represented management's good faith judgement, and (3) was accompanied by a statement which disclosed the basis upon which such
information was calculated and the imprecisions inherent therein." If adopted, this release was designed to limit liability under the anti-fraud provisions of the securities laws, given that the above three conditions were met by registrants. The SEC has created an advisory committee to assist in the implementation of ASR 190 and other associated releases. The committee of 29 is made up of members from industry, public accounting and academia.

These three releases will be discussed in the following section since all three are concerned with replacement cost accounting and represent a composite of the SEC view on the implementation issues.

The Rational for the Release of ASR 190

Evidently, the SEC is concerned about the growing disparity between the market values of assets and their book values. A substantial part of this discrepancy may be due to inflation. However, the specific and general price impacts on aggregate current values are likely to vary significantly from industry to industry. While recognizing that the issuing of supplemental statements based on general price-level accounting is one method of attempting to make published statements more meaningful, the SEC has opted for supplemental information on the replacement costs of certain assets. That approach disregards the isolation of general price-level impacts on a company. However, ASR 190 stresses that is proposal is not "competitive with that of the FASB" which we discussed above and identified as a GPLR approach.

The SEC recognizes the costs associated with the gathering of replacement cost data but evidently feels that investor interest, especially in the case of larger companies, is such that "the benefits of disclosure clearly outweigh the costs of data preparation." They note that actual cost data supplied to them by companies which had produced replacement cost information was considerably below cost estimates supplied by other companies.
Further, the SEC recognizes that requiring replacement cost data for certain fixed assets and inventories is not as comprehensive as some would like. However, they note that, fixed assets and inventories are the principal operating resources of a business, and that additional information is provided to investors, in the form of replacement cost data, for certain other assets (i.e., marketable securities) or that transformation of historic cost data is possible (i.e., monetary assets).

While recognizing that ASR 190 is a dramatic departure from present reporting requirements, the SEC suggests that such a departure is appropriate. They do not feel that the probable **lack of precision** of the replacement cost data will be reason enough for its exclusion. "In a business world characterized by uncertainty, it is necessary to recognize that many estimates based on subjective judgements must be included in financial statements and that appropriate means of describing the uncertainties and the lack of precision must be found."

**Staff Accounting Bulletin No. 7**

SAB 7 specifies that there is no limit to the amount or type of additional information that may be provided. It **does not** preclude the use of general price-level restated data. Instead, the SEC suggests that management may wish to supply such information if they feel that it would be useful to disclose the inflation impact on current values. Nor does it preclude the inclusion of net realizable or economic values. However, neither general price-level restated data nor net realizable values may be used in lieu of replacement cost. SAB 7 does provide an additional year for implementation for applicable assets that are located outside North America and the European Economic Community. This temporary release also applies to resources in the extractive industries.

**The "Safe Harbor" Rule Proposal**

The Commission believes that the "safe harbor" rule should reduce the concern
of both reporting companies and Public Accountants about issuing statements that include imprecise data. If care is taken in the preparation of the data, and if the data have been computed on a reasonable basis in good faith and if the basis of computation and limitations inherent therein are disclosed, the disclosures shall be deemed not to be deceptive, misleading, false, etc. Of course, from a practical standpoint, it is very difficult, if not impossible to specify in advance just how the SEC will choose to interpret these three requirements. Since, in order to become operational, some policy maker must apply his own interpretation to the meaning of those words it is hard to guess the actual outcome for specific registrant cases. There are very likely to be honest differences of opinion between the SEC and registrants regarding their meaning; therefore, the "safe harbor" may in fact have some hidden shallows ahead, even for the most wary of "sailors."

SEC-FASB Conflict

Interestingly the SEC does not believe that requiring the inclusion of replacement cost data in the financial statements is in conflict with the FASB's attempt to develop a conceptual framework for financial reporting. However, it is difficult to imagine how SEC dictates in this area will not have an impact on the FASB's work. Nor is it reasonable to assume that the SEC position will not have an impact on the future development of accounting policy in both Canada and the United States. In defending its position, the SEC argues that the replacement cost data will be supplemental and does not represent a change in the "accounting model." In fact, the SEC seems to believe that the requirement "will encourage meaningful experimentation ... and ... will assist the FASB in addressing the broad conceptual and practical issues involved." They are unclear, however, as to exactly how "experimentation" will be tolerated in materials submitted to meet the SEC disclosure requirements.
In summary, the SEC seems to believe that supplemental information designed to reflect the growing disparity between market and book values is needed and that the requirements of ASR 190 are a first step toward providing that information.

Auditor Association With ASR 190 Data

The information filed in compliance with ASR 190 may be included either in the footnotes or in a separate section of the form 10-K financial statements. The information must be included in financial statements filed with the SEC but need not be included in the published annual report. However, if the detailed information is excluded from the annual report, mention must be made in the report that the detailed disclosure information is contained in the 10-K on file with the SEC. In addition, the procedures used to develop the data must be disclosed in the 10-K and it must also include any other information which is deemed necessary to prevent the data from being misleading.

Information filed in compliance with ASR 190 may be designated unaudited but since the information will form part of the financial statements, the SEC makes it clear that the auditors will be associated with it. The specific SEC intent in its emphasis of association in this context is not altogether clear. From the individual public accountants' point of view in the United States, association will require the application of Generally Accepted Auditing Standards including, as a minimum, a disclaimer of responsibility for the disclosures, if that is appropriate. However, since explicit treatment of the issue of auditor involvement is contained in the text of ASR 190, it seems reasonable that the SEC may expect that involvement means something more than unaudited. Just what the effect of this requirement will mean to auditors in an operational sense is unclear. It seems reasonable to assume, however, that because of this associative relationship some review of the current value disclosures mandated by ASR 190 will be required of a firm's auditors.
Meaning of Replacement Cost

Replacement cost is defined by the SEC as "the lowest amount that would have to be paid in the normal course of business to obtain a new asset of equivalent operating or productive capability... depreciated replacement cost is the replacement cost (new) adjusted for the already expired service potential ..."[30]

Productive capacity is defined as a measure of the ability of a company to produce and/or distribute products. Land, unless it is consumed in production is excluded as are intangible assets. Productive capacity that is not to be replaced and obsolete or discontinued inventory may also be excluded. However, fully depreciated fixed assets that are still being used are included.

IMPLICATIONS FOR REPORTING BY PUBLIC COMPANIES IN CANADA AND THE UNITED STATES

In the short term relatively smaller companies will be free from meeting the disclosure requirements of the SEC. Larger companies, however, will certainly be very pressed to gather data necessary to meet the requirements within the time constraint set by the SEC. Because of the short lead time, there will probably be little effort devoted to developing systems and techniques to support the continuing information requirements of the SEC. However, in the longer range, it seems likely that the implications of the SEC action both for setting policy, and for establishing financial accounting standards will be significant. It is the purpose of the following sections to present our view of some of these possible developments.

Issues of Cost vs. Benefit

A substantial amount of theoretical and empirical research has been completed which addresses the reaction of security markets to accounting reports and
announcements of other accounting information. The interested reader may wish to refer to a policy oriented paper on this subject recently published by Professor William H. Beaver of Stanford University. The policy implications of this vast research are significant. First, one major implication is that insiders are able to earn abnormal profits in securities transactions using information available only to them. These abnormal profits are socially undesirable in the sense that these profits are derived at the expense of those not having access to that information. There is general agreement that the disclosure of relevant insider information would quickly be reflected in security prices, and hence limit the opportunity for these speculative profits. The implications for the ARC, FASB or SEC as policy making bodies seems clear. A primary question seems to be, is replacement cost information with respect to inventories and productive plant, insider information not now properly reflected in security prices? If this is so, there is a socially desirable benefit associated with its disclosure. A second primary asks, what is the likely cost associated with gathering and reporting the information? Is the benefit/cost relation such that the policy should be adopted? Clearly, these are difficult questions not lending themselves to ready solution. However, some type of reasoning along these lines should certainly be an integral part of policy setting. It is not clear that such an analysis preceded the SEC policy decision in this matter.

Policy Establishment

Another somewhat broader question developing out of the events detailed in this paper has to do with who should establish financial accounting standards? While the SEC asserts that ASR 190 will not interfere with the activities of the FASB, and in fact claims that the result should be an enhancement of the current policy study of the FASB regarding a conceptual framework, an observer is hard
pressed to find facts to support this claim. It seems reasonable to assume, based on previous experience that the SEC is willing to up-stage privately established accounting rule making bodies, if developments in those organizations do not seem to suit the tenor of the Commission. This bodes ill for the hope of developing a sound private-sector professionally founded basis for the development of standards in financial accounting. One need not speculate far to imagine the implications for the practice of public accounting in the future, if this type of rule making becomes more pervasive.

Meaning of Replacement Cost Data Generated

There are at least two dimensions of the measurement requirements of ASR 190 which should be considered in evaluating the SEC disclosure requirements. First, since partial data requirements form the basis for the disclosure rule of ASR 190, it is unlikely that users of financial statements will be able to easily discern the total impact of current value shifts on a firm. Certainly, there are significant changes in the current value of debt and equity securities which also have an impact on the economic circumstances of the firm. It is somewhat puzzling that this type of disclosure was not also made a requirement of ASR 190 since ready markets exist for most equity securities and debt rendering the measurement process relatively straight forward.

Secondly, and more fundamentally, it is generally well known that the specific price of any asset is a function of not only the specific markets in which it is traded, but also a function of movements in the general price-level. For example, in circumstances in which the general price-level increases relatively more than the specific price of a non-monetary asset, the real impact on firm wealth associated with holding such an asset is negative. Since the SEC has emphasized in ASR 190 an attempt to display some of the underlying economic circumstances of the firm, surely, real impacts on firm wealth should be a required
disclosure. Consideration of movements in the general price-level are not a required part of the disclosure, therefore, real impacts on changes in asset values will be masked by shifts in the general price-level in the data disclosed.

Auditor Involvement

In many ways, one of the developments which is likely to have a significant impact derives from the unaudited nature of the disclosures. As we indicated previously, since the disclosure will be part of financial statement information filed with the SEC, the auditing firm will be understood to be associated with the current value disclosures. This suggests an evaluation of the current value estimation and presentation process according to standards which have not yet been formulated by the accounting profession. It is difficult to know the degree of liability assumed by an auditing firm in circumstances like these. Certainly, as a minimum, professional accounting bodies will need to address the promulgation of standards for review of materials in the current value area in response to the situation thrust upon them by the SEC. This would seem a desirable step, not only to provide guidance in the audit process, but to provide a measure of professional auditing standards which are generally agreed to, as a possible defense in case of later litigation directed toward an auditing firm by the SEC or by others.

CONCLUDING COMMENTS

It seems reasonable to assume that the current effort of the ARC in the preparation of a discussion paper on current value accounting will be in some way influenced by the policy setting activities of the SEC. Similarly, the activities of the FASB in the United States in its deliberations regarding the specification of a conceptual basis for accounting will of necessity need to be sensitive to the direction taken by the SEC. In fact, it seems unlikely, based on current
developments, that such a body could successfully adopt any financial accounting standard which seemed to conflict with public policy as specified by the SEC. This suggests a somewhat different future for the development of accounting policy which may rely more heavily on dictates of government policy setting bodies, and rely less heavily on professional organizations as a basis for setting standards. The authors feel this is a sad result in light of the hopes many had for the role that groups like the ARC and FASB could play in developing reporting standards.

On the positive side, certainly many have advocated the use of current values in financial reporting. The action of the SEC has guaranteed that current value measurement will become an operational activity, at least for larger companies. It seems reasonable to assume that after an initial experimentation period, smaller companies will also be included in the disclosure requirement. This data generation process should provide sufficient information to conduct more meaningful research on the results of reporting the data to investors, and may serve as a positive force in the development of new approaches to reporting the financial activities of publicly held companies.
Footnotes


5 In this circumstance, inflation accounting refers to the general price-level restatement of historical cost measures to a common dollar basis. This procedure does not deal with current values, except in the circumstance in which the current value of specific assets owned by an entity happened to coincide with their general price-level restated amounts. For a good discussion of the distinction between these valuation concepts, the interested reader may wish to refer to Sterling, Robert R., "Relevant Financial Reporting In An Age Of Price Changes," The Journal of Accountancy. (February, 1975), pp. 42-51.


7 Canadian Institute of Chartered Accountants, Accounting For Changes In The General Purchasing Power of Money, (July, 1975), CICA, Toronto, Ontario.

8 Ibid., p. 2.


11 Ibid., pp. 61-115.


14 Ibid., p. 12.


18Ibid., p. 1.

19Ibid., p. 1.

20One additional bit of business seems pending in this area involving a research report of the empirical investigation conducted by the FASB in the GPLR area. The report will summarize the effects of GPLR resulting from the field tests, and will also discuss techniques of restatement including certain short-cut procedures.


22SEC (ASR 190) op. cit., p. 1.


25SEC (ASR 190) op. cit., p. 6.

26SEC (ASR 190) op. cit., p. 4.

27SEC (ASR 190) op. cit., p. 5.

28SEC (ASR 190) op. cit., p. 7.

29SEC (SAB 7) op. cit., p. 2.

30SEC (SAB 7) op. cit., p. 2.
