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ACCOUNTING IN AN INFLATIONARY ECONOMY

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WILLIAM L. NEMEREVER, NEAL N. STANLEY.**

1. Explanation of inflation accounting and techniques thereof as it impacts income statements and balance sheets
2. Inflation accounting as it impacts corporate planning for life companies
3. Stock market efficiency on inflation-adjusted earnings

MR. BOBBY F. DUNN*: Probably the most talked-about issue in the accounting profession today relates to the profession's reaction, or overreaction, to the mounting criticism, particularly from economists and financial analysts, that current financial statements don't "tell it like it is." Many economists and others say present-day financial statements do not take proper account of the effect of inflation. The profession first tried to deal with the inflation problem back in 1969 when the Accounting Principles Board came out with a pronouncement, Statement No. 3, entitled "Financial Statements Restated for General Price Level Changes." This pronouncement was generally ignored by the profession.

The Financial Accounting Standards Board (F.A.S.B.) has come out with an exposure draft dated December 1974 entitled "Financial Reporting in Units of General Purchasing Power." Comments on this draft had to be in by September 30. I am sure the F.A.S.B. has received a flood of comments because, as you will see, there is a great deal of room for disagreement about their solution to the problem of accounting for the effects of inflation.

Forbes, in its August 15, 1975 issue, said the following: "What worries us about the accountants is the profession's occasional tendency to make things worse in a sincere but confused effort to make them better. The latest case in point is the Financial Accounting Standards Board's exposure draft on inflation accounting which is now being circulated through the profession and through industry generally. The proposal is, in essence, to apply a single purchasing power adjustment to all figures of all companies and report the figures so adjusted as a supplement to the regular historical figures."

In order to visualize what the F.A.S.B. is proposing, here is a very simple example of how the F.A.S.B. proposal would work.

Let us assume that the XYZ Company was formed January 1, 1975 and sold \$1,000 in common stock. The company bought a depreciable asset for \$1,000 of which \$500 was paid immediately and \$500 is due January 1, 1976. The salvage value of the asset is zero with a 5-year life span. Depreciation is on a straight-line basis. The only revenue is from rental of the asset and the only expenses are depreciation and income taxes. We assume that the general price level index during 1975 rose from 100 on January 1 to 110 on December 31 on a uniform basis throughout the year.

*Mr. Dunn, not a member of the Society, is a Partner of Peat, Marwick & Mitchell, Chicago, Illinois.

DISCUSSION—CONCURRENT SESSIONS

Thus the average index was 105. All revenues and taxes are received or paid evenly throughout the year.

XYZ COMPANY
BALANCE SHEET
(Historical-dollar basis)

<u>ASSETS</u>	<u>January 1, 1975</u>	<u>December 31, 1975</u>
Cash	\$ 500	\$ 800
Depreciable asset:		
Cost	\$1,000	\$1,000
Less depreciation	<u> -</u>	<u> 200</u>
Total	<u> \$1,500</u>	<u> \$1,600</u>
<u>LIABILITIES</u>		
Accounts payable	\$ 500	\$ 500
Common stock	1,000	1,000
Retained earnings		100
Total	<u> \$1,500</u>	<u> \$1,600</u>

XYZ COMPANY
STATEMENT OF INCOME
Year Ended December 31, 1975
(Historical-dollar basis compared with
general price level basis)

	<u>Historical dollar</u>	<u>General price level</u>	<u>Conversion notation</u>
Rental revenues	\$ 400	(\$75) \$420	(\$400 x 1.05)
Depreciation	200	220	(\$200 x 1.10)
General price-level loss	<u> ---</u>	<u> 15</u>	(1)
Income before taxes	200	185	
Income taxes (at 50%)	<u> 100</u>	<u> 105</u>	(\$100 x 1.05)
Net Income	\$ 100	(\$75) \$80	

(1)

Monetary assets - cash	
January 1	\$500
December 31	800
Average	<u> 650</u>
Less monetary liabilities	500
Average net monetary assets	150
X inflation %	<u> 10%</u>
General price level loss	<u> \$ 15</u>

XYZ COMPANY
BALANCE SHEET
December 31, 1975
(General price level basis)

Cash	(\$75)	\$800
Depreciable asset:		
Cost (\$1,000 x 1.10)	\$1,100	
Accumulated depreciation (\$200 x 1.10)	220	880
Total	(\$75)	\$1,680
Accounts payable	(\$75)	500
Common stock (\$1,000 x 1.10)		1,100
Retained earnings		80
Total	(\$75)	\$1,680

This example illustrates the principles involved and gives some idea of how difficult this whole process might be to apply in the "real world."

What would be the results of applying this new method of reporting to actual companies? Not many companies have made actual calculations; however, Dr. Sidney Davidson of the University of Chicago and three of his associates have attempted to approximate the effect of general price level reporting on a number of companies. For instance, they applied their approximations to the companies making up the Dow Jones Industrial Average. As calculated by Dr. Davidson, the reported earnings on this group of companies for 1974 would have been nearly 12% less than historical reported earnings. But the effect can vary greatly by company, for example:

- Allied Chemicals - earnings would have been 10% less.
- Alcoa Aluminum - 32% greater.
- American Brand - 69% greater.
- Bethlehem Steel - 17% less.
- Eastman Kodak - 18% less
- International Harvester - 57% less.
- Proctor & Gamble - 2% less.
- U. S. Steel - 21% less.
- United Aircraft - 59% less.
- Westinghouse Electric - 18% greater.

So it's difficult to generalize about the effect of applying the F.A.S.B. proposal. It depends on the mixture of monetary and non-monetary assets and liabilities that go into the measure of general purchasing power gains or losses, the extent of leverage, capital assets used in the business, and other factors.

Moving a little closer to home, let's take a look at a regulated industry.

The following comes from Dr. Davidson's work, and applies the general purchasing power adjustments to the public utility industry.

DISCUSSION—CONCURRENT SESSIONS

ELECTRIC UTILITIES EARNINGS, FASB-STYLE

Utility	Adjusted Income			Common Share Earnings	
	Reported 1974 income (Millions)	Before gain on monetary items (Millions)	Including monetary items (Millions)	Reported	Adjusted
American Elec. Power	\$176	\$117	\$488	\$2.06	\$7.21
Cleveland Elec. Illum.	61	45	127	3.68	9.60
Commonwealth Edison	180	108	395	2.88	8.21
Consolidated Edison	209	148	499	2.68	8.79
Consumers Power	61	23	202	1.34	8.31
Detroit Edison	89	55	255	1.46	6.00
Houston Lighting & Power	69	54	149	2.92	6.98
Niagara Mohawk Power	96	65	216	1.70	4.86
Pacific Gas & Elec.	261	179	515	3.27	8.24
Philadelphia Elec.	129	94	294	1.81	5.94
Public Service Elec. & Gas	154	106	351	2.35	7.03
Southern Calif. Edison	218	169	409	4.10	9.76

Source: Financial Analysts Journal, September/October, 1975.

And you thought that utilities were having trouble! Herein lies one of the main points I want to make. It is true that utilities would be making substantial economic gains as a result of all of their leverage, provided they were generating increasing revenues from the assets purchased with their debt issues. The problem is, utility rates are regulated and, at present, regulators will not allow the utilities to include a replacement cost or general purchasing power depreciation charge in their rate base. Therefore, while utilities may be able to pay their debts with dollars having less than current purchasing power, the fact of the matter is that they are not likely to be able to generate additional dollars through rate increases to pay such debts. So I don't give much credence to any implication that American Electric Power's earnings would be more meaningfully stated at \$488 million instead of \$176 million.

It's not difficult to see what is coming next. If utility companies show increased earnings (in terms of general purchasing power) because they owe a lot of money, the companies that own utility bonds must conversely be losing a comparable amount. Who owns the utility bonds? While a few life insurance companies may have privately made calculations to see how they would come out under the F.A.S.B. proposal, I have not seen the results of any such calculations. The following is my own crude approximation of the effects of the F.A.S.B. proposal on an actual (but disguised) life insurance company, ABC Life Insurance Company.

The first step is to identify the monetary and non-monetary assets and liabilities, and the F.A.S.B. has been kind enough to provide some guidance about which is what. It is clear that cash and bonds are monetary assets,

preferred stocks with a sinking-fund provision are probably monetary, and preferred stocks without a sinking fund are probably non-monetary, the same as common stock. Mortgage loans would obviously be monetary; real estate would be non-monetary; policy loans, monetary; furniture and equipment, non-monetary. Now we come to deferred acquisition costs. If you asked ten actuaries, I'm sure nine would say they are monetary because they are so closely related to reserves that you can't separate the two. On the other hand, if you asked ten accountants, at least nine would say deferred acquisition costs are non-monetary the same as a prepaid expense in a commercial company. In doing my earnings calculations, I chose to side with the actuaries, as the calculation is much more straightforward and I tend to agree with their logic.

That brings us to the liability side of the balance sheet. The gut issue is: are policy reserves monetary or are they non-monetary? In my opinion they are monetary because, even though the aggregate amount depends on an estimate of persistency, mortality, and interest, we are dealing with fixed-dollar contracts.

Almost all other life insurance company liabilities are monetary, except for deferred taxes and stockholders' equity, which the F.A.S.B. has defined as non-monetary.

ABC LIFE INSURANCE COMPANY
Balance Sheet (000's omitted)
December 31, 1974

<u>ASSETS</u>		<u>M</u>	<u>NM</u>
Cash	5,000	X	
Bonds	241,000	X	
Preferred stocks:			
With sinking fund	5,000	X	
Without sinking fund	4,000		X
Common stocks	15,000		X
Mortgage loans	270,000	X	
Real estate	35,000		X
Policy loans	63,000	X	
Furniture and equipment	8,000		X
Deferred acquisition costs	66,000		?
Other assets	10,000	X	
	<u>722,000</u>		
<u>LIABILITIES</u>			
Policy reserves	543,000		?
Policy claims	3,000	X	
Other policyholder funds	30,000	X	
Mortgage note payable	9,000	X	
Deferred taxes	13,000		X
Other liabilities	6,000	X	
	<u>604,000</u>		

<u>LIABILITIES, Cont'd</u>	<u>M</u>	<u>NM</u>
Stockholders' equity:		
Capital stock	23,000	X
Paid in	1,000	X
Unrealized investment losses	(6,000)	X
Retained earnings	<u>100,000</u>	X
	<u>118,000</u>	
	<u>722,000</u>	

M=Monetary

NM=Non-Monetary

Now let's examine the effects of applying the general purchasing power theory to ABC's statement of earnings.

ABC LIFE INSURANCE COMPANY
Statement of Earnings
Year ended December 31, 1974
(Assuming 10% inflation)

Net earnings historic (statutory basis)	<u>9,000</u>
Net earnings historic (G.A.A.P. basis)	12,000
General purchasing power adjustments:	
Net adjustment to operating accounts other than depreciation	550 (1)
Additional depreciation	(500) (1)
Additional loss on investments	(1,000) (1) (2)
Net purchasing power loss	<u>(6,900) (3)</u>
Net earnings (general purchasing power)	<u>(74) 4,150</u>

(1) Rough estimate

(2) Resulting from necessity to recompute the cost basis to cost stated in terms of current purchasing power. For example, a stock bought in 1958 for \$100 would have an adjusted general purchasing power cost basis of approximately \$165 in 1974. Therefore such stock, if sold for \$120 in 1974, would be recorded at a \$20 historic basis profit but would have a \$45 loss in terms of general purchasing power.

(3) Monetary assets before deferred acquisition cost (DAC)	594,000
DAC	<u>66,000</u>
Monetary assets including DAC	<u>660,000</u>
Monetary liabilities before reserves	
Policy reserves	48,000
Monetary liabilities including reserves	<u>543,000</u>
	<u>591,000</u>

(3) Cont'd

Excess of monetary assets over monetary liabilities	69,000
Inflation	<u>10%</u>
Net purchasing power loss	<u>6,900</u>

I have not applied this type of analysis to enough life insurance companies to be able to state whether ABC Life Insurance Company is typical. I do believe, however, that it is safe to conclude that the vast majority of life insurance companies' earnings restated in terms of general purchasing power (using the current F.A.S.B. recommendations) would be substantially less than earnings based on historic dollars.

I will leave it up to the reader to decide whether \$9,000 (statutory earnings), \$12,000 (historic G.A.A.P. earnings), or \$4,150 (general purchasing power earnings) more fairly presents ABC's earnings for 1974.

MR. NEAL N. STANLEY: I will limit my remarks to a discussion concerning the response prepared by the American Life Insurance Association on September 26, 1975 to the exposure draft issued by the Financial Accounting Standards Board on December 31, 1974 entitled "Financial Reporting in Units of General Purchasing Power." This response states, "After careful study we have concluded that the information which would be called for by the proposed statement in its present form would be misleading"...And after several other sentences the response states, "We therefore recommend that the proposed statement not be adopted."

The Committee on Life Insurance Company Financial Reporting Principles of the American Academy of Actuaries also responded to the exposure draft. The response of the Committee stated, "Our committee is taking no position as to the desirability of presentation of financial information expressed in units of general purchasing power." The Academy Committee, however, did proceed to do a very fine job, in my judgement, of pinpointing the problems which the exposure draft presented. Solutions to these problems will have to be found if the exposure draft ever becomes implemented; however, the prospects seem at least fair that the business community will be spared this implementation, not because the business community rebelled at the attempt to impose this costly, unnecessary, and incomprehensible doctrine, but because the S.E.C. entered the picture with its own view of what should be done. While the requirements of the S.E.C. and the requirements of the Exposure Draft on Financial Reporting in Units of General Purchasing Power are not mutually exclusive, they are so basically different that it does not seem probable that both would be required as footnote disclosures to a historical cost financial statement. It also seems probable that the S.E.C.'s more limited requirements of certain replacement cost data covering inventory, equipment, and property is more likely to prevail.

The American Life Insurance Association response which recommended that the exposure draft not be adopted was approved by unanimous vote of the Committee on Financial Reporting Principles after receiving the unanimous recommendation of the Sub-Committee appointed by its Chairman. I will not take time to go into details of the response made by the ALIA. I do want to give you the general outline of what the Committee agreed upon and also to give those reasons which caused me, personally, to conclude that the exposure draft should not be implemented. For that purpose I am quoting from my letter to the members of the Committee written August 20, 1975.

My thoughts on the general consensus of those attending the meeting were:

Since it is true that inflation has an impact on the financial results of an operation, and since that impact does not fall equally on all companies alike, it is difficult to raise a valid objection against an attempt by the accounting profession to measure the consequences of inflation. If any opposition is to be raised against the exposure draft, such opposition would need to be justified on the basis that the benefits are not worth the cost, or that the exposure draft methods do not provide an adequate solution to the problem.

There seemed to be general agreement that it could not be demonstrated that the cost of complying with the exposure draft methods is out of proportion to the benefits to be derived because it was generally felt that the cost would not be very large. Thus, even if the benefits are small, which some members of the Committee believe, the corresponding cost is also relatively small.

There seemed to be general agreement that if the concepts of Financial Reporting for General Purchasing Power Accounting is approved for financial statements in general, there would seem to be no basis for an exemption for life insurance companies, although I, for one, would see little utility in such accounting for mutual life insurance companies.

There seemed to be general agreement on the part of the Committee that the exposure draft itself is defective in its classification of balance sheet items neatly into monetary or non-monetary items. There seem to be many assets and liabilities that do not lend themselves to such a simple classification. There was also expressed some feeling that more meaningful results would be obtained if the financial statements were expressed in results of dollar units fixed in the past, say, in 1968 dollars rather than in terms of purchasing power at the date of the balance sheet which causes prior-period statements to be continuously adjusted. Also, there was some thinking that the use of only one GNP deflator to cover all adjustments is not realistic.

There seemed to be some thought that the exposure draft was written primarily for manufacturing and commercial enterprises that are heavily affected by depreciation charges for plant and equipment, inventories, and cost of goods sold, rather than for financial institutions. It was the opinion of some on the Committee that a much more simple and less costly approach could be developed for financial institutions.

Finally, there appears to be some thinking that asset classification as to monetary or non-monetary which might be appropriate for general commercial firms with only limited investments is not necessarily appropriate for a financial institution whose entire balance sheet is comprised of investments, and certain liabilities peculiar to the life insurance industry are not even mentioned in the exposure draft. Such items as life reserves, health reserves, and deferred acquisition costs could possibly be interpreted by accounting practitioners as non-monetary unless the life insurance industry can establish from the beginning that the correct classification for such items is monetary. Also, we do not agree that deferred taxes are non-monetary as stated in the exposure draft.

There are a few general philosophical thoughts on the general topic of price level accounting which I, personally, feel should be given some thought:

- (1) Is not the assumption of future inflation implicit in the suggestion that price level accounting is necessary? Does not the implicit assumption that there will be future inflation cause inflationary expectations and management decisions that create the very inflation being assumed? Since policyholders of life insurance companies, and life insurance companies themselves are hurt by inflation, should not the life insurance industry resist any accounting proposals which tend to recognize the fact that inflation is "normal"?
- (2) In order to maximize earnings under general price level accounting, it would appear that management should invest assets in non-monetary items, such as common stock and real estate, while avoiding cash and top-grade bonds. At the same time it should incur long-term monetary debt rather than create common stock equity. Such a course of action by a financial institution resulting in illiquid and unstable assets and heavy fixed charges would generally be regarded as folly, and yet a company with such a balance sheet would show better results under general price level accounting than would be shown by a company maintaining good liquid assets, conservative investments, and a sound capital structure. Should accounting methods be proposed and adopted for financial institutions which would tend to cause a shift from monetary to non-monetary assets and a shift from non-monetary to monetary liabilities? I think we should consider that Real Estate Investment Trusts would have looked very good under general purchasing power accounting.
- (3) If the concepts of general price level accounting are accepted as producing more realistic results than historical accounting, as the Arthur Andersen opinion on the Indiana Telephone Corporation states, would not the impact be inflationary? For example, the Toledo Edison Company showed that the return on net plant investment was 9% under traditional accounting but only 5% under price level accounting while return on equity was 11% and 6%, respectively. It takes little imagination to suppose that the utility industry will argue that it is entitled to higher rates to offset the higher depreciation charges under price level accounting even though the property being depreciated was not actually purchased with current dollars. Whether the higher rates based on imaginary depreciation charges are appropriate or not might be debated, but higher charges for utilities are certainly inflationary. Should the life insurance industry, whose policyholders are hurt by inflation, support a method of accounting which, if used as a basis for pricing, would produce more inflation?

I find it difficult in my own mind to understand why an investment of \$10,000,000 in a utility plant should be repaid by customers with depreciation charges adjusted for inflation while an investment of \$10,000,000 in a mortgage on that plant by a life insurance company should be repaid by the utility in unadjusted dollars; yet I can visualize such a result as a consequence of price level accounting.

I guess the result of the above thoughts leads me to the conclusion that the consequences of the adoption of general price level accounting could produce no beneficial results, only harmful results, for financial institutions in particular and the public in general. I would be pleased if other members of the Committee could show me that this conclusion is in error.

Finally, it is my own personal conviction that, more than other industries, the

life insurance industry has an obligation to fight inflation, not measure it. The essence of our product is the delivery of dollars tomorrow in exchange for dollars today. The industry, therefore, has a duty to do everything within its power to see that the dollar tomorrow which it delivers to the beneficiary is not unreasonably diminished in value when compared to the dollars paid today by the insured. Therefore, management in the life insurance industry through its every action--investments, salary administration, product pricing and cost control--must have high on its list of priorities the determination to maintain a stable dollar in this nation. The solution to the problem of accounting for inflation in this country is not the adoption of the exposure draft on general price level accounting. The solution to the problem of accounting for inflation in this country is the implementation by our Congress, our Managements, and our Labor Unions of policies which will eliminate the need for such accounting.

MR. WILLIAM L. NEMEREVER: The question of inflation accounting is a real one. As early as 1947, the American Institute of Certified Public Accountants had published material recommending methods of coping with the losses in purchasing power brought about by inflation. In Europe and the United States, for some time, certain companies have produced inflation-adjusted statements.

As a user of financial statements, an investor requires the best information possible to determine changes in the real economic state of the firm over the reporting period. In modern accounting, the balance sheet, income statement, and statement of changes in financial position are really mathematical models which try to answer an investor's question of what changes in real wealth and earnings potential have occurred over the accounting period. I look upon inflation accounting -- and within this concept I would include both price level accounting as proposed by the Financial Accounting Standards Board and replacement cost accounting required by the SEC -- as just a refinement of the accounting model.

In 1973, the accounting profession published a report on the objectives of financial statements known as the Trueblood Report. A brief mention of several of its specific objectives is important:

- First: "To serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
- Second: To provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty.
- Third: To provide users with information for predicting, comparing, and evaluating enterprise earning power."

All of these build on the report's foundation: Financial statements are to provide information useful for making economic decisions. All that inflation accounting does is allow those interested in the real financial progress and potential of a corporation to obtain a better picture of economic reality. While there has been, and will continue to be, a great deal of discussion about the ultimate form, methodology, and degree of inflation-induced changes in financial statements, the objectives are clear. Before dealing with the specifics of life insurance company inflation accounting, I'd like to explore for

a moment how historical dollars can be very misleading units of measurement in inflationary times.

As a securities analyst, I am called upon to evaluate the potential, both long and short term, of my industries to grow with the economy. To the extent that they lag the economy they are generally unattractive. To the extent that they fare better than the economy, they are generally attractive. A large part of the success one can have in projecting financial variables for companies or industries depends upon an accurate perception of economic history.

I have taken a number of economic time series for the U.S. life insurance industry and restated them in 1972 dollars by means of the recently-revised GNP deflator. While I had heard it said that this industry is a mature one, the exercise of restatement in dollars of constant purchasing power drove this point home.

The period examined covered the past ten years, 1966 through 1975. During this time, nominal GNP grew at a little better than 8.1% per year, while GNP in constant dollars grew at about 2.7% per year.

For the life insurance industry:

- Total assets grew at 6% per year in historical dollars, but remained essentially flat in real terms.
- Total purchases of life insurance advanced at an annual rate of slightly less than 11%, but grew about 3.4% in real terms.
- Average policy size for ordinary insurance in force grew a little faster than 5.5% per year, but was unchanged in real terms.
- Nominally, ordinary insurance premiums grew about 5.7% a year and total premiums from all sources about 9%. However, in real terms, these figures were reduced to practically zero for ordinary insurance premiums and a little better than 3% for total premium income.
- Ordinary insurance in force increased at slightly better than 8% over the 1966-1975 period in historical dollars, but in real terms the rate was 2.8%, about the same as real GNP growth.
- Finally, ordinary benefit payments grew about 6% a year in nominal terms, but in constant dollars have remained substantially unchanged over the last ten years.

The point of all this is that measurement of financial variables in real terms is more realistic in times of inflation than historical dollar methods. It allows the manager or the analyst to separate gains due to productivity from changes due to fluctuations in the general price level. A firm that can grow in real terms is clearly a better investment than one that cannot; even though both may exhibit historically attractive rates of growth.

I'd like to turn now to the question of life insurance inflation accounting. An investor in the life insurance industry, or any industry for that matter, is interested in obtaining an accurate picture of the changes in economic wealth over time, and the sources of these changes. To the degree that inflation influences the real position of the industry, or the companies of which it is composed, it must be considered.

In applying price level inflation accounting to financial industries such as life insurance, the most important adjustment involves the relationship between monetary assets and monetary liabilities held over the reporting period. To the extent that monetary assets such as cash, bonds, and mortgages exceed monetary liabilities such as policy reserves and dividend accumulations, a company is exposed, in a period of price level inflation, to a loss in purchasing power. Of course, if the net balance favors monetary liabilities, a gain in purchasing power results and earnings, in real terms, are increased. I thought it would be interesting if I could develop some industry statistics which would allow us to draw some general conclusions about the magnitude of inflation accounting adjustments. However, as you all are aware, the best and most readily available data from the Institute of Life Insurance is on a statutory basis. Industry-wide GAAP data is not available. I was able to discover that my general feeling that the industry, due to its traditional structure, has been and will continue to be perpetually in a position of holding net monetary assets is not necessarily the case. In the years 1965 through 1969, the U.S. legal reserve life insurance companies did report, on a statutory basis, a net monetary asset position. Since 1969, however, in the aggregate, this position has swung heavily to produce positions of net monetary liabilities. The point to be made here is that each company must be examined individually, preferably on a GAAP basis, including the operations of subsidiaries.

The next step in my investigation of the consequences of a price level restatement involved the analysis of an actual company. The company chosen is a large stock life insurance company with a wide institutional investor following. Earnings reported in 1973, 1974, and 1975, and projected GAAP earnings for 1976 were restated.

The restatement used the methodology prescribed in the FASB exposure draft, "Financial Reporting in Units of General Purchasing Power."

The procedure involved adjusting the income statement to balance-sheet-date dollars and incorporating the loss incurred due to holding net monetary assets over the year.

One problem arose in deciding whether to treat deferred acquisition costs and the associated deferred tax liabilities as monetary or non-monetary. My intuitive feeling was that they were monetary since they represented dollars already expended and would be amortized against a premium income stream established on the same historical-dollar base. However, the FASB exposure draft advises one to treat deferred income taxes as non-monetary because, "they represent a deferred past cost that will be amortized to expense in future periods." Since I can see some merits in arguments for both the monetary and non-monetary classification of these items, I took the easy way out and developed restated figures for each point of view.

Although I had been vaguely aware of the effects of these adjustments, I was very surprised at the results.

If deferred acquisition costs and deferred taxes are treated as non-monetary, the reductions in reported earnings for the years 1973 through 1976 are:

1973	16%
1974	26
1975	29
1976	21

If the deferred items are considered to be monetary, the reductions are:

1973	32%
1974	50
1975	50
1976	35

An interesting by-product of this exercise is the effect it has on some of the traditional financial ratios used in common stock analysis. For example, before adjustment, the return on shareholders' equity for the four years considered is in the 11 to 12% range. After adjustment (treating the deferred items as non-monetary) this falls into the 8 to 9% range. Including deferred items with monetary assets and liabilities produces returns on equity in the 5 1/2 to 7 1/2% range. The dividend payout ratio before adjustments is in the 17 to 20% range. The first stage adjustment, excluding deferred items, advanced this to the 20 to 28% range, and the second stage adjustment, including deferred items, moved the range even higher, to 25 to 40%. Finally, the implied growth rate, measured as net income less common dividends, divided by shareholders' equity, had been averaging a little better than 9% throughout the period 1973 through 1976. However, the first stage adjustment reduced this to a range of about 6 to 7 1/2% and the second stage even further, to a range of about 3 to 5 1/2%.

I would say that, as a result of the foregoing, this company is not as strong as was initially perceived and shapes up less favorably as a candidate for investment.

In conclusion, I'd like to make the following observations.

- It appears that the consensus is that higher-than-traditional rates of inflation are going to be with us for some time. The Institute of Life Insurance's "Ratchet Scenario" paints a very dark picture for the industry. Chase Econometrics doesn't see inflation going below a 5% annual rate any time in the next ten years. Most-likely-case projections by Data Resources, another firm specializing in econometric forecasting, are nearly as gloomy. Financial analysts should use the tools at their disposal to obtain the best picture of the operations of a life insurance company. Inflation-adjusted earnings are an important by-product.
- There is quite a bit of controversy surrounding the price level approach to inflation accounting. Companies such as utilities, with capital structures heavily weighted by debt instruments, look very good under this approach. The SEC currently favors the replacement cost approach which clearly has more meaning in industrial companies. For these and other reasons, I would suggest that it isn't necessary for stock life insurance companies to restate their earnings on a price level basis. Modest additional disclosure of items, such as monetary assets and liabilities, will give analysts what they need to perform the restatements. I would submit that anyone knowledgeable enough to interpret company-produced price-level-adjusted financial statements is equipped to perform the mechanics himself. This would avoid any confusion created by more than a single earnings number, minimize the problems of conforming with FASB statements, and maintain the current number of company personnel, as well as the number of auditors involved in the reporting process.
- To the extent that a company management finds itself in a net monetary asset position, this new emphasis on price-level-adjusted earnings should

provide some additional incentive for managing monetary balances. I like to think of an insurance company's balance sheet exposure to inflation as being very similar to a multinational corporation's exposure to currency fluctuations in the countries in which it operates. Failure to pay attention to the degree of foreign exchange exposure can result in losses similar to those resulting from the maintenance of net monetary positions.

The most serious consequence of maintaining a net monetary asset position is that it will impair a company's ability to grow in real terms during periods of inflation. There is very little chance that we will return to the modest level of advances in price level experienced in the early 60's. Company managements must pay attention to and minimize exposure to inflation because it is certain that analysts consider this an important factor in the making of investment decisions.