SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES ACT OF 1933
Rel. No. 5449/January 3, 1974

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 10580/January 3, 1974

ACCOUNTING SERIES
Rel. No. 151/January 3, 1974

DISCLOSURE OF INVENTORY PROFITS REFLECTED IN INCOME IN PERIODS OF RISING PRICES

The year 1973 was a period of rapidly increasing prices in the United States when compared to historical economic norms for this country. During the year consumer prices rose by about 8 percent, wholesale prices by about 16 percent and the crude industrial materials component of the wholesale price index by about 30 percent. There were wide fluctuations in the prices of individual items.

Under such conditions the usefulness of the traditional accounting measurement model based upon historical cost is significantly reduced. The process of matching costs against revenues is less likely to produce meaningful economic information if the costs were incurred at a time when the price level associated with such goods and services differed significantly from that at the time when revenues were realized.

While a continuation or acceleration of the rate of price-level change might require a fundamental change in the basic accounting measurement model used in preparing financial statements, it would be premature for the Commission to suggest such a change at this time. Careful consideration of the many implications of such a major step would be necessary both by the Financial Accounting Standards Board and by the Commission. At the same time, it does not seem appropriate that registrants and accountants should simply ignore the impact of rapidly changing prices on financial statements.

The most significant and immediate impact of price fluctuations on financial statements is normally felt in cost of goods sold in the income statement. In periods of rising prices, historical cost methods result in the inclusion of "inventory profits" in reported earnings. "Inventory profit" results from holding inventories during a period of rising inventory costs and is measured by the difference between the historical cost of an item and its replacement cost at the time it is sold. Different methods of accounting for inventories can affect the degree to which "inventory profits" are included and identifiable in current income, but no method based upon historical cost eliminates or discloses this "profit" explicitly. Such "profits" do not reflect an increase in the economic earning power of a business and they are not normally repeatable in the absence of continued price-level increase. Accordingly, where such "profits" are material in income statements presented, disclosure of their impact on reported earnings and the trend of reported earnings is important information for investors assessing the quality of earnings.

In recognition of the need for additional disclosure in regard to inventories and cost of goods sold, the Commission recently proposed amendments to Regulation S-X (Securities Act Release No. 5427, October 4, 1973) which would require registrants to indicate "the effect on net income, if significant, of using current replacement cost [for valuing inventories] in the computation of cost of sales." To date the Commission has received a large number of comments on this proposed disclosure and the effectiveness of that requirement in eliciting information about "inventory profits." The comments also indicated that problems of implementation existed. The Commission has given careful consideration to these comments and has concluded that it would not be desirable to adopt final requirements in this area which would be effective for 1973 financial statements. At the same time, the Commission recognizes that the impact of "inventory profits" on currently reported earnings appears to be significant in many cases and that failure to make appropriate disclosure may result in investors being inadequately informed as to the source and replicability of earnings.

The Commission therefore believes that it would be in the best interest of both statement preparers and users to disclose the extent to which reported earnings are comprised of potentially unrepeatable and usually unsegregated "inventory profits." Accordingly, the Commission urges registrants to make disclosure of such amounts prior to the adoption of final requirements by the Commission. Such disclosure may be made in the financial statements, the notes thereto or in textual material accompanying financial statements.

The Commission recognizes that registrants usually do not compute cost of goods sold on both an historical cost and current value basis so that computation of such amounts may often require estimation by the registrant. It is also recognized that computational methods or bases of valuation other than current replacement cost for each item sold might be used in developing useful information about such "profits." For example, computing the cost of goods sold for each month using a price-level adjusted inventory amount might produce a reasonable and useful estimate of such "profits" in some cases. Until final requirements are established, registrants are encouraged to use any method or basis deemed appropriate by management in exhibiting the impact of such "profits" along with a statement of the method or basis used and the reasons for adopting it.

The determination of cost of sales on a current replacement cost basis, however, provides only partial information regarding the effects of inflation on a company's operations. A second factor is the responsiveness of a company's selling prices to changes in costs. If a company is able to raise selling prices immediately upon realizing cost increases (or in anticipation of cost increases), its net income in dollar terms benefits from inflation. On the other hand, as price increases lag behind cost increases the benefit of inventory "profits" is offset and the net inflation effect on income may be negative. Because of various regulatory restraints on prices, many companies may have experienced significant pricing lags in the current year.

The impact of price-level changes does not fall equally among companies. Some firms operate in sectors of the economy where prices of goods purchased are more volatile than selling prices. Accordingly, the Commission urges registrants to discuss the relationship of costs and prices experienced in the current year in connection with disclosing inventory profits.

By the Commission.

George A. Fitzsimmons
Secretary