# THE IMPACT OF THE WAR ON ACCOUNTING

Address by Wm. M. Werntz, Chief Accountant, Securities and Exchange Commission, Before the Philadelphia Retail Controllers' Association, February 16, 1943

I plan to discuss the problems presented in the preparation, under war conditions, of reliable and informative financial statements for public investors. Generally speaking, these problems fall into two broad fields: first, the effect of the manpower shortage on normal auditing and accounting procedures, and, second, the reflection in financial statements of the special conditions created by the war. By far the most important of this latter group is the increased uncertainty involved in determining the facts necessary to effect a proper accounting, and, in interpreting, from an accounting viewpoint, the many new and unusual business arrangements and relations that have arisen.

The most pressing auditing problem is clearly the manpower problem. Accountants, no less than business and government, are finding it increasingly difficult to secure personnel with the requisite professional qualifications, while at the same time the demands for accounting services are constantly increasing. In addition, the drain of personnel from private business, at a time when production is at a peak and methods are often entirely new, has meant that internal controls formerly in force and upon which the public accountant could properly place reliance, are no longer fully effective. Consequently, in spite of the shortage of manpower, the audit made by the public accountant requires even greater diligence and care than formerly.

The Securities and Exchange Commission has been directly interested in this problem since it affects two things on which the Commission has placed considerable reliance: the <u>accounting systems of companies</u> and the <u>certificates of independent accountants</u>. Fortunately, there is a general feeling both on our part and in the accounting profession that the situation should not be met by relaxing auditing standards in an effort to give some attention to all demands although adequate attention may thereby be given to none. Under existing rules such a general relaxation would presumably result in disclosure of the omitted procedures and qualification of the accountant's certificate. In such event, appraisal of the extent to which the reliability of the financial statements had thereby been reduced would be most difficult.

Any general relaxation without disclosure in the certificate would be even more serious and would undoubtedly subject the accountant to heavy liabilities. In either case, the confidence that could be placed in the certificate would be seriously impaired. The problem is not one to which there is a ready solution. However, the Commission and its staff have cooperated with the accounting profession through correspondence and conference in an effort to find ways and means of best meeting the situation.

## Inventory Verification

Perhaps the auditing problem which has most frequently arisen as a result of the war has had to do with the wartime application of the "Extensions of Auditing Procedure". One of the earliest problems of this sort to arise had to do with the problem of inventory verification. Even before our entry into the war, it became obvious that the need for an uninterrupted flow of war materials was likely to mean that in some cases it would not be possible to delay or stop the production process for the purpose of taking complete physical inventories and that the accountant would therefore be unable to apply his usual physical tests. If inventories were material in amount, a failure of the accountant to make these objective tests would be a departure from normal auditing standards applicable in the circumstances and would, from our point of view, subject the certificate to the citation of a deficiency.

In recognition of this situation, the Commission's Accounting Series Release No. 30 was issued early last year. That release codified an administrative policy, adopted some months before, of accepting accountants' certificates notwithstanding that the normal procedure of physical verification could not be applied with respect to war inventories.

At the last annual meeting of the American Institute of Accountants — in order to cover such situations — the membership of the Institute voted to amend the Extensions of Auditing Procedure to provide specifically that any departure from the extended procedures required by that bulletin be disclosed in the accountant's certificate. Also a bulletin dealing with the specific problem of wartime inventory verification has been issued by the Committee on Auditing Procedure of the American Institute of Accountants. As I read it, this bulletin indicates that the profession's requirements in connection with this inventory problem are substantially the same as those of the Commission.

## Confirmation of Receivables

Much the same situation has arisen with respect to the confirmation of receivables. To an increasing degree companies are finding a substantial portion of their current assets, and even total assets, made up of receivables due from the government. In general, however, the government procurement officers have not been able to respond to requests for confirmation of amounts owing. The issues raised are quite similar to those involved in the inventory question just considered.

So far the Commission has not issued any official release on the subject. However, inasmuch as confirmation of receivables is a normal auditing procedure where receivables are material in amount, it appears necessary, under our existing rules, for the accountant in his certificate to state that confirmation has not been had with respect to government receivables, to give the reason, and to indicate briefly the supplemental procedures employed to support the amount shown as accounts receivable from the government. If the auditor is satisfied with the results of his work in this connection, no exception as to the fairness of presentation would be necessary in the certificate, but again, if the auditor has not been able reasonably to satisfy himself, his certificate should contain a clearly stated exception. On this question the Committee on Auditing Procedure of the American Institute has issued a bulletin that sets standards quite similar to those just outlined.

## Increase in "Uncertainty"

In the field of statement presentation and accounting principles, the most striking effect of the war has been, as I mentioned earlier, the increase in uncertainty. In a few directions, of course, the war has operated to reduce uncertainty. Emphasis is no longer on sale but on production or acquisition, and in very many lines production has risen toward capacity.

With large sales to the government and relatively stringent credit restrictions imposed on consumers, the estimation of bad debts becomes generally less difficult. On balance, however, the uncertainties involved in financial reporting in a partially controlled economy under the stimulus of war production and with foreign investments and corporations often in a precarious status, are considerably greater than formerly. The task of presenting adequate financial statements is correspondingly much more difficult. Moreover, as was indicated, the war has brought into existence a variety of novel legal or contractual arrangements. As to many of these, there is by no means complete agreement among accountants generally, or between accountants within and without the Commission, as to how to give effect to these conditions in the annual statements.

The Commission is greatly interested in the solutions developed for these problems, since one of its most important tasks is to obtain for investors reasonably complete and informative financial data. While present circumstances clearly increase the margin of possible error in financial reporting, it is not a satisfactory solution merely to refrain from issuing statements, as some suggest, or to abandon efforts to arrive at reasonable estimates and substitute sweeping but unhelpful disclaimers.

War and Post-War Reserves

Perhaps the next most important source of uncertainty lies in the conditions which have given rise to the so-called war and post-war reserves. The extensive list of possible reserves appended to the bulletin of the American Institute of Accountants gives an excellent idea of the breadth and significance of the problem.

For the pruposo of discussing the problem of statement presentation, such reserves appear to fall into four major classes. There are those, the provision for which must be considered a direct cost of doing business, as for example accelerated depreciation. While the exact provision needed for this purpose may be somewhat indefinite, the factors underlying the provision are not dissimilar from those encountered in arriving at regular depreciation reserves, and presumably they should occupy in the statements a position analogous to the usual depreciation reserves. In many cases indeed, the condition is cared for by "stepping up" the annual provision in view of the 24-hour use of the facilities. In the second class, we encounter those conditions or losses for which provision must be made before arriving at an estimated income for the year, ordinarily as a rather clearly defined item of extraordinary deductions. Generally, the limits of the contingency or condition involved are somewhat less definite than in the first category of cases, but there exists, nevertheless, a reasonable conviction of loss applicable to the period and reasonable evidence on which to base an approximation of its amount.

In the third category, we pass to those contingencies, usually much less definite, for which a reasonable approximation of the provision necessary is scarcely possible. These may pass almost imperceptibly over into a fourth category, the "general contingency" reserve which is set up as an appropriation of surplus, a sort of cautionary retention or earmarking of surplus against the vicissitudes of the future. The bulletin mentioned suggests the deduction of provisions for reserves of the third category at the very bottom of the income statement, almost as an appropriation of income rather than as a clear deduction in computing it.

The presence or absence of conditions necessitating the provision of reserves of any or all of the types mentioned is by no means easily ascertained. The determinability of amounts, given the conditions, varies widely. Nor is it possible to say, even, that particular conditions should always give rise to reserves of a particular category. As between companies, for example, the same general problem, say inventory losses, may so vary in particular aspects as to make appropriate a reserve in any of the categories.

The problem of deciding upon the proper point at which a provision for a reserve should be deducted is most difficult of decision. To the extent that these reserves are designed to provide for losses that may properly be chargeable against income, their provision seems proper or even necessary. However, it also should be recognized that there are limits beyond which the use of appropriations of income should not go. Certainly an indiscriminate establishment of reserves out of income to provide for losses whose character is wholly undisclosed and may even be unknown to the company is a practice that can be badly misleading. Likewise the commingling of unrelated contingencies in a reserve with a vague, all-inclusive title is to be condemned. Clearly, too, the provision and use of reserves allegedly to meet war conditions should not be a disguise for the ancient but none the less vicious practice of equalizing profits between years. Accounting Series Release No. 42 was recently issued to indicate and emphasize the requirements of Regulation S-X as to the creation and description of reserves.

## Inventory Reserves

Of the various kinds of wartime reserves currently being provided, those likely to be of greatest interest to you are the reserves set up with respect to inventory losses. An increasing number of companies filing financial statements with the Commission have found it necessary or desirable as a result of war conditions to establish reserves against such losses. In general, these reserves have either been provided in recognition of a present impairment of inventory carrying value or in recognition of future inventory losses that appear possible or probable.

Reserves of the first type have been fairly common in the past and have been considered necessary in circumstances where inventories would otherwise be carried at more than recoverable cost. Present conditions, however, may have somewhat reduced the extent to which companies are subject to such losses. On the other hand, the possibility of future inventory losses as a result of war or post-war contingencies has considerably increased and has frequently resulted in the provision of reserves for such losses. Reserves of this type have been set up in varied situations that make generalizations as to their establishment or use difficult. In some cases, the reserve may be intended as the equivalent of an inventory write-down and so may be properly carried as an offset against inventories and charged to income or costs. On the other hand, some of the losses contemplated may be so indefinite or remote or so dissociated from the <u>present</u> inventory that the reserve should be provided from surplus and considered as merely a sub-division thereof.

A rather difficult series of cases arise in the middle ground between these two extremes. For instance, in some cases inventories have been stated at current cost but this cost has been in excess of probable peacetime carrying values. Some companies have provided reserves in the estimated amount of the differential and have charged income for the provision. This procedure has been criticized on the ground that such an anticipatory charging of a loss to income results in shifting the burden of the loss from the period when it actually occurs to the period when the reserve is provided. On the other hand, the procedure may be intended to accomplish a result similar to that obtained under the base stock inventory method. Much depends on the kind of inventory and on the character of the business. In other cases it has been most difficult to ascertain whether future contingencies are sufficiently real to warrant charging income and establishing a reserve for the possible loss.

Neither the accounting profession nor the Commission has issued any general pronouncements on the particular subject of inventory reserves. Thus far the situations presented have often been unique and have been dealt with on the basis of the facts peculiar to the case. Possibly experience gained in observing the establishment and use of these reserves will permit some further clarification of the principles to be observed in their operation.

## Use of Last-In First-Out Method of Inventory Valuation

The basis used in determining the amount at which inventories are carried has some effect on the need for providing inventory reserves. In this connection, it is interesting to observe that in the past two years there has been an increasing use of last-in, first-out as a method of determining cost. The result of adopting this method of valuation at the present time is ordinarily to reduce the amount at which inventory would otherwise be carried. Hence, it has an effect that is similar to the provision of a reserve for inventory losses. In fact, some persons have suggested that the adoption of Lifo should be recommended as a quasi wartime reserve.

Some indication of the extent of the shift to Lifo and the materiality of its effect on reported income may be found in figures taken from the Survey of American Listed Corporations for 1941. Figures for about 230 registrants have been published in Reports 1 through 9 of that series. About 6% of those registrants had changed to Lifo in 1941 as a basis for costing all or part of their inventories. Perhaps more significant, however, is the fact that reported net income after taxes of companies shifting to Lifo would have been greater by 12% if the change in basis had not been made. In some cases, net income was affected as much as 50%, while in other cases the effect was not material.

The question whether a particular company should adopt Lifo as a basis for determining inventory cost is not easily answered and time does not permit an exploration of the subject. However, it seems to me to be quite evident that the decision should not be solely dependent on the desirability of providing wartime reserves, or of minimizing taxes as some have suggested, but should depend primarily on whether that method of determining inventory cost best reflects the inventory position of the particular company. Therefore, it may be assumed that a decision to change to Lifo will be a firm decision that is not subject to reversal unless the characteristics of the company's business are materially altered. Certainly, Lifo should not be employed as a temporary measure to reduce current profits in the expectation of increasing profits or reducing losses in later years by a return to the method formerly used for determining the cost of inventory.

## Accounting for Post-War Refund of Excess Profits Tax

Another interesting problem in determining proper accounting procedure is raised by Section 250 of the Revenue Act of 1942 which provides for a 10% post-war refund of excess profits taxes paid by corporations. This credit, as you may know, is to be granted in the form of government bonds of a special series which are to be issued to the taxpayer after payment in full of his excess profits tax for a given fiscal year. The bonds, however, may not be sold, transferred, or hypothecated, as may an ordinary investment. They are not to bear interest until the end of the war, and are to mature at stated intervals after the end of the war.

Various suggestions have appeared as to the proper method of accounting for this credit. First, it has been suggested that no recognition be given to the bonds until they are redeemed. A second, somewhat similar proposal, would require that no entry be made in the accounts, thus treating the credit as a sort of general wartime reserve, disclosed, if at all, only by means of footnotes. This treatment is said to give effect to the purpose of the credit, as described in the Senate report: to provide "a fund that will be available for the conversion of production facilities after the war to peacetime demands." Under this latter proposal the tax provision would be shown gross without any reduction for the 10% credit. A third proposal was to show the tax gross, take up the bonds as an asset and establish a war reserve equal thereto. A fourth option would be to report the tax provision at the net amount, disclose the amount of the refund credit, recognize as an asset the right to receive these bonds and report as a liability the gross amount of the excess profits tax.

Of these several possibilities, it seems to me that this last option is the proper one. To record the provision for excess profits taxes without a reduction for the 10% post-war refund that will inevitably result from the payment of these taxes is tantamount to denying any present value to the credit or the bonds. This seems to

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A record must also be kept by each organization for the amount of units received from the time the ration order went into effect on February 7th, until the second phase of the year.

While you do not have to pay for these units at the present time, it will be necessary to pay for these units when the second phase of the year comes in.

Once the second phase of the year is in operation, the manufacturer, jobber, or any other shipper can not send merchandise unless stamps covering this merchandise are in his hands.

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me to be an insupportable position to take with respect to a right to receive government bonds which, while not transferable nor interest-bearing at the time received, nevertheless have an unquestioned value that approximates their face amount. Certainly it would seem improper to credit the amount of the bonds directly to a reserve for post-war contingencies. The need for post-war reserves in a particular case is quite unrelated to the amount of such tax refunds. If such reserves should be set up, their determination should be wholly dependent on the need for the reserve and the propriety of its establishment.

If it be granted that the tax provision should be shown net and the asset recognized, then there remains the relatively simple question of the proper balance sheet presentation of this asset which represents a right to receive a partially "frozen" asset. Inclusion in current assets is improper. Presumably a presentation toward the foot of the balance sheet among "Other Assets" would be a fair showing.

(Editor's Note: Mr. Werntz closed his address by summarizing the changes announced last year in the requirements as to information, and which were adopted because of the difficult conditions now existing. Lack of space prevents us from including them in the present Balance Sheet, but interested parties may obtain Release No. 2887 from the S.E.C., covering these changes.)

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## SIMPLIFIED BILLING IS WORKING AT KRESGE'S

The recent widespread interest in simplified billing is due to the impetus of the Kresge, Newark, N. J., practice. On the following page we are presenting a copy of the form letter which was mailed by that store to its customers prior to the receipt of their first simplified bill.

We have also been informed that the stores in Buffalo, N. Y., have decided to adopt simplified billing.

For further details on the Kresge practice and experience we refer our readers to an article by J. Anton Hagios, Manager of the N.R.D.G.A. Credit Management Division, entitled "Consumer Credit Outlook - - Immediate and Future - - Regulation W", and which appeared in the last month's issue of the Balance Sheet (February).