TRENDS IN ACCOUNTING

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Two years ago, I had the pleasure of discussing before this conference some of the problems facing accountants because of the war emergency — renegotiation, provision of war reserves, losses on investments, tax uncertainties, censorship restrictions, and necessary adaptations of audit procedures, among others. Solutions to those problems that were on the whole satisfactory under the circumstances and with respect to immediate objectives were fortunately developed even though I expect that from the vantage point of later years there will be a good bit of sound criticism offered. Many of the practices may also be characterized later on as aberrations from what by then will have emerged as the course of accounting progress.

For this meeting I have been asked to discuss the subject "Trends in Accounting." During the past four years or so, there seems to me to have been a lapse in the arguments between those holding differing views as to the functions of financial accounting and of general financial statements. I do not mean that war problems were resolved without regard to such issues, but rather that in arriving at solutions those holding differing views on this question agreed upon procedures which were in effect compromises, in which the most significant element was disclosure. I may point for an example to the practice of deducting certain reserve provisions from net income and calling the remainder "balance transferred to surplus."

It is time now, I think, to reopen the discussion as to what the purpose of general financial statements should be and, in particular, the purpose of the income statement. In my opinion, there is no more important single question at issue today. Differences, even uncertainty, of opinion on this question lie at the heart of nearly every accounting ~~question~~ problem which today is being hotly discussed — whether it be what should be done with post-war costs that are linked with the war effort, or what recognition should be accorded "tax savings," or what should be done with unused war reserves, or what treatment should be followed with respect to cash payments for goodwill and other intangibles or how bonus and compensation stock or options should be recorded.

I think the present a peculiarly appropriate time to re-examine this fundamental question on the basis of the case material which war-time financial statements provide. In them can be found, over and over again, actual and often extreme illustrations of the stock problems that in years before the war were conjured up in debates over the purpose of financial accounts and the merits of proposed treatments. The material is largely pathological, but its study is no less important and useful here than in the medical fields. It is the more useful indeed becuase many of the problems that now press for solution are the embarrassing aftermath of the practices followed in dealing with the immediate needs of the war period.

Probably the principal division of opinion so far as the fundamental purpose of accounts is concerned arises over the question of whether the income account should be so designed as to arrive at a figure which is reasonably indicative of the results of operations under "normal" conditions or whether it is intended to portray in summary form all of the profits and losses that have been or, better, should be recognized in the current year. The issue was pretty well drawn in the literature which sprang up following publication by the American Accounting Association of its statement of Accounting Principles Underlying Corporate Financial Statements. This was first published some years ago and was revised and republished in 1941. The basic arguments pro and con that are being advanced today are not essentially different although their outward appearance has been adapted to changes in current practices and procedures. A good example of this development is found, I think, in the citation of the current form of accountant's certificate as support for the proposition that the income statement should not reflect the results of unusual items. You will recall that the certificate includes the language "fairly presents .... the results of operations" for the current year. Some accountants insist vehemently that such language cannot be used with respect to an income statement which reflects a material profit or loss on a transaction that relates to the operations of any other year or years — for example, a tax refund, a loss on property sold, a lump sum payment for past service annuities and so on. Substantially the same position is implicit, it seems to me, in the following key language of Bulletin 23, Accounting for Income Taxes, issued by the Committee on Accounting Procedure of the American Institute of Accountants:

> "As a result of such [unusual] transactions the income tax legally payable may not bear a normal relationship to the income shown in the income statement and the accounts therefore may not meet a normal standard of significance."

The very same difficulty is involved in more prosaic language when the issue is whether inclusion or exclusion of a particular item will "distort" the income statement. The difficulty in arguments over the meaning of all such terms as "fairly presents," "normal standard of significance," "abnormal" or "distort" is our lack of agreement as to what financial statements are supposed to mean. Until some sort of agreement is reached, everyone can use such terms in support of his own opinion or in criticising his opponent's.

Opinion may not perhaps be so far apart as might be supposed from some of the arguments that arise over individual cases. Language can be found in many of the Institute's Bulletins and in the writings of those advocating the current operations principle to the general effect that there is at least a presumption in favor of the charging of items to income. There are also various statements that certain items must be charged or credited to income. However, most of these statements are coupled with an exception where the item is of such a size as to "distort" the income account. In practice, [redacted], there seems to be a tendency for accountants, both public and private, to agree with the general proposition that all items, or nearly all, should go through the income account, but to maintain that the particular item then under discussion is an exception to the rule or is one which would "distort" the income account if included therein. The real difficulty in such cases is again a lack of agreement as to the fundamental purpose of the income account.

The first step toward arriving at an understanding in this matter is not, it seems to me, the formulation of a declaration of faith. The first step, in my judgment, is to make a purely factual analysis of past experience — a critical survey of past financial statements and how particular items were treated. We might even do a little exploratory work to see if any correlations can be established between practices and results in terms of success or failure of business enterprises, of market values and earnings, or of relation between practice and stages of the business cycle. Two things are fairly certain — I think — first, some examples of <u>all</u> variations of practice can be found; second, the only practice that has <u>not</u> been given a thorough and widespread trial is the proposal to put all items of income and loss into a single statement.

After this sort of marshalling of past experience has been completed, there ought to be some pretty serious discussion as to why particular items were put in or put out of the income statement. When these two steps have been taken will be the time to come to grips over whether the purpose of the income statement is such as to permit the exclusion of certain items from it.

A beginning along these lines has been made. We have taken 164 representative listed companies in 53 industry groups and examined their financial statements for the years 1939 through 1943. 90% of the companies were found to have one or more entries to earned surplus during the five-year period, excluding dividend items and annual net profit or loss transfers. Somewhat over half the companies had such surplus entries in each year. In all there were 900 entries or 1 per company per year. Half of the entries involved amounts in excess of 5% of net income.

We also sought to classify the types of surplus entries and ascertain the extent to which comparable items were charged to income by the same or other companies. I will not attempt to catalogue in detail the results of this part of the inquiry, but it clearly indicated that a large number of identical items were charged to income by some companies and to surplus by other companies. A few companies charged similar items to income in one year and surplus in another year. Furthermore, we found that all the companies that made no charges or credits to earned surplus (except for dividends and transfers of income) had charged or credited income with some material items that were similar in character to those charged or credited to earned surplus by the other companies.

We have attempted, so far without success, to find some rationale which could explain the inconsistent treatment within companies and between companies. It is apparent that no consistent explanation of the practices followed can be based on the size of the item involved. For example, one company reported net income for the five-year period of $47 millions, dividends of $45 million and a decline in surplus of $8 million, or 16% of reported income. Another company reported income of $62 million, dividends of $26 million and an increase in surplus of only $6 million. On the other hand, other companies charged items of the same nature to earnings. In one case, the items were 114% of net income (exclusive of such items) for the years involved. In another, 24%, in a third, 21%.

If the nature of the items, rather than their size, be considered, we get the following results: Material tax adjustments affecting prior years were charged to income in 30 instances and to surplus in 59. Similar but immaterial items were charged to income in 64 instances and to surplus in 64 instances. Past service pension, retirement and annuity costs were charged to income in 16 cases and to surplus in 18 cases. In one case a company made annual charges of this item to surplus for 8 consecutive years in amounts that aggregated about 10% of total income for those years. Material losses on sales of fixed assets were charged to income in 54 cases and to surplus in 9 — a most astonishing story in view of the long use of a sale of capital assets as the stock illustration of the typical surplus item. In the case of investments, however, charges to income were made in 80 instances, of which 32 were material; but there were 94 instances of charges to surplus, of which 57 were material.

An interesting sidelight on the factual description of past practice is gained by analyzing the items in terms of those certified by the same accounting firm. We find as much or more dispersion in results. Thus, three firms certified statements that reflected material charges for past service annuities without regard to whether the charge was made to income or earned surplus. As to tax adjustments, there were nine such firms. As to losses on investments in subsidiaries there were three. As to losses on fixed assets there was 1.

One last approach may be made — using, for the moment, per share earnings as a yardstick. One company reported income of 36¢ per share. Had it followed another and apparently equally acceptable practice, it could have shown $1.79 per share. In the prior year a loss of 37¢ per share could have been reported as a profit of $1.72 per share. In another instance, the possible range was from $6.78 to $8.99. In a third case, a company showed $3.01 but could have shown $1.60. A close competitor which reported 40¢ could have shown $2.34. In a fourth case, a company which reported $3.11 per share could have shown $2.86, $3.11, $3.87, 3.90, 4.12, $4.15, $4.91 or $5.16 merely by its disposition of 3 items of the kind under discussion.

On the basis of my review of this study, I have been forced to these conclusions:

(1) There exist no accounting criteria as to when an item may be excluded from the income statement — I do not say practice is hit-or-miss, but that the effective considerations do not appear to have been accounting principles.

(2) Accountants have accepted the situation and have been willing to certify statements, either on the basis that they conform to their own view of the particular matter or on the ground that in the absence of effective criteria they are unable to object.

(3) By a choice as between income and surplus it is possible to vary reported earnings, within very wide limits.

Not all those who have been considering this question feel that a serious problem exists. I note particularly the report of a subcommittee of the Committee on Accounting Procedure, which is printed at page 205 of the September Journal of Accountancy. Point 2 of the statement reads:

> "(2) Statistical material kindly made available by the Chief Accountant of the Securities and Exchange Commission and other data prepared by the Research Department of the Institute do not indicate that the investing public is being misled to any considerable extent by questionable treatments of such items."

Of course, the study which I have outlined and which the subcommittee mentions does not prove that anyone, investors included, has in fact been misled. I think it does clearly show that practice in this field is so inconsistent, and so devoid of any unifying principle as to be readily susceptible of misuse and misunderstanding, to the very probable detriment of investors not expert in accounting matters.

With these general considerations in mind, we may take up for consideration a question of much importance, at least during this year and next. I have in mind the treatment of post-war costs, expenses and losses that on one basis or another may be said to relate to, or have been brought about by, the war emergency.

First I think it helpful to survey briefly the factual situation. Listed companies today reflect in their statements several billions of dollars provided for war reserves. Earned surplus has increased an additional several billion dollars, much of it attributable to companies which set up no war reserves and which appear to regard part of all of their surplus as in effect a war reserve. Perhaps three-fourths of the war reserves were provided by means of charges immediately before or after net income. The remainder were set up out of surplus. Judging by the captions given the reserves, no clear distinctions between them can be drawn from the manner of their creation. Also using the captions of reserves together with any explanatory notes as an indication of their purpose, it is apparent that few of the reserves were designed to cover a specific and limited possible or probable loss. On the contrary, most of them specify at least several types of losses and in a great many instances indicate that the specific situations mentioned are merely intended to characterize the general type of items for which the reserve is provided. Indeed, it might not misstate the case to say that most such reserves are so captioned as to embrace any and all costs or losses attributable to war operations whether or not specifically foreseen. In other words, the philosophy expressed in Bulletin 13 of the American Institute of Accountants has not worked out well or been closely followed in practice. Finally, such reserves are found not only in companies engaged in the production of war material, but in nearly all types of companies, including department stores, retail chains, and manufacturers whose war contracts consisted entirely of peacetime products. This prevalence of reserves in all kinds of companies was to be expected since the effect of war measures and war shortages required adaptation in businesses far removed from the actual production of war goods.

Second, I think it necessary to recognise that many costs and losses that will occur or be recognised in this year and at least the next will be much more closely related to wartime operations than to peacetime operations. Ideally, such items ought to be so treated that their nature and amount will be brought clearly to the attention of the user of the financial statements. All will agree on this much. Strong disagreement will be met, however, if one goes further and proposes to have all such items included at some point in the income statement, either with or without the return of reserves previously provided. Others will object to the charging of such items directly to war reserves or to surplus, even if an analysis of such reserves or surplus is provided. Still others, in deference to previous reserve accounting practices, will permit direct charges only if the reserve was clearly and specifically provided for the particular item. These will be met, however, with the rather persuasive argument that all of the problems in fact grew out of the war and that in the interests of uniformity we should not have different accounting as between companies simply because one happened to be more astute, or maybe just luckier than the other.

Much of the difference in approach to the problem flows from a difference in belief as to what the income statement is supposed to reflect — the same problem that I outlined earlier, but in a very exaggerated form. Differences of opinion on this score cannot, I fear, be resolved in time to do much good so far as the treatment of the war cost situation is concerned. They could, of course, be settled out of hand by agreement or requirement, justified on the basis of an overriding need for uniformity in this difficult period.

The first and perhaps the foremost difficulty encountered in putting this ideal of segregation into practice is to define a "war cost or loss." As pointed out earlier, nearly every kind of business has been affected by the war and so may encounter costs which in a broad sense are attributable directly or indirectly to the war period. However, as one gets away from those businesses which can be seen to have physically converted to the production of war material, it becomes increasingly difficult to be sure that a particular item of cost or expense is a result of operations during the war and is not partially or perhaps largely the result of post-war policies and decisions. The same is true, even in purely war businesses, when one gets beyond such items as the dismantlement of a machine used solely for war work or a loss on war inventories not suitable for peacetime products, and turns to questions of expenditures for establishing or refurbishing sales organizations, reacquainting customers with old products, or retraining employees. The difficulties seem to me to increase when it is remembered that a great many companies may not be going back to exactly the same kind and volume of production and methods of distribution.

Once the full scope of the problem is examined I begin to have much doubt that it will be possible to arrive at a definition of war costs of sufficient clarity as to permit of reasonable uniformity in application. It may even be impossible to agree upon a satisfactory "concept" of war costs. If such fears materialize, there would be serious danger that the reader of financial statements would fail fully to comprehend the term as used in the financial statements. Or he might easily be misled in making comparisons between companies whose application or understanding of the term was quite different. Finally, it seems to me very possible that neither the certifying accountant nor a reviewing body such as our staff will, except in unusual cases, be in a position to arrive at an intelligent judgment as to the propriety of a company's classification of an item as a war cost. When to these problems are added the variety of accounting treatments that are acceptable for unusual items of this kind, and the known variations in past practice with respect to the creation of war reserve, it is very obvious that a most difficult problem faces the draftsman of financial statements during the next year or two.

What final or best solution of this problem will emerge, I do not know. I should like, however, to offer the following tentative suggestions as a basis for discussion:

(1) A special effort should be made to identify in the statements such material items as are considered to be closely related to operations during the war period.

(2) The disposition of such war items in the accounts should be made very apparent.

(3) By footnote or otherwise a statement should be made as to the definition or principle followed in deciding whether a particular item is or is not a war item, and as to the company's general policy in dealing with them.

(4) War reserves should not be carried forward to future periods in amounts exceeding what it is expected, in the clearer light of today's knowledge, will be properly chargeable to them.

It will be seen that this proposal places principal reliance on full disclosure as the means of protecting the reader of financial statements. I am inclined to go further and suggest that a substantially uniform method of disclosure ought to be required. I doubt, for example, whether the mere inclusion at some point in the statements of an analysis of surplus or war reserves will be adequate, particularly if what are considered to be war items appear in two or more parts of the statements. Instead, I think very serious consideration ought to be given to the desirability of some such required procedure as this: First, in the income statement show clearly any items which are regarded as "war charges" - or "war credits" for that matter. Second, immediately after the final figure of net income, show as a statistical tabulation a figure comprising all of the charges and credits which occurred during the period and are considered to be "war items," together with the distribution of such amounts as between income, reserves or surplus. Third, a reference should be made to a tabular presentation (which might in appropriate cases be the surplus or reserve analysis) breaking down the total war items into a reasonable number of descriptive categories. Fourth, the statement of principle followed by the company in identifying war items and the accounting policy as to them should be prominently displayed and cross-referenced.

Where the income statement covers both war and non-war operations, I rather doubt that the above proposal should be considered to cover costs of production that are applicable to war sales and have been computed on a basis consistent with that followed in prior years. It would seem desirable, however, to subdivide sales, where practicable, as between the two classes of business. Possibly in appropriate cases a similar segregation of costs of sales could also be made.

The time available does not permit me to explore with you some of the other war problems that are pressing for solution. Principal among them is the treatment to be accorded war facilities erected and written off under certificates of necessity but still highly useful. Somewhat the same question is involved, incidentally, in distinguishing war costs from those expenditures that ought to be capitalized and charged off against future operations.

I want next to turn to a question on which our practice has now rather fully crystallized. I have in mind the question of "tax savings" or, as I would much prefer to call them, "tax reductions." This again is in many respects mostly a war problem since the amounts involved are usually minor except where war-time tax rates are in effect. I discussed the problem in some detail at the 1943 meeting of this Conference. Since then we have had many cases involving a great variety of circumstances. And a good deal has been written on the subject. Neither the cases nor the intervening arguments have provided evidence which seems to me to contradict or undermine the tentative conclusions we had then reached. However, the application of those principles has been refined in the light of more recent cases and as a result of many lengthy discussions between the Commission, its staff and various accountants and companies. At the present time our views can be summarized as follows:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws.

2. It may be appropriate, and under some circumstances such as a cash refunding operation it is ordinarily necessary, to accelerate the amortization of deferred items by charges against income when such items have been treated as deductions for tax purposes.

3. The use of the caption "Charges or provisions in lieu of taxes" is not acceptable.

4. If it is determined, in view of the tax effect now attributable to certain transactions, to accelerate the amortization of deferred charges or to write off losses by means of charges to the income account, the charge made should be so captioned as to indicate clearly the expenses or losses being written off.

5. The location within the income statement of any such special charge should depend on the nature of the item being written off. In the case of a public utility, for example, a special amortization of bond discount and expense should not be shown as an operating expense but should be classified as a special item along with other interest and debt service charges in the "other deductions" section.

6. It is appropriate to call attention to the existence of the special charge by the use of appropriate explanatory language in connection with intermediate balances and totals.

7. In the preparation of statements reflecting estimates of future earnings, it is ordinarily permissible to reflect as income taxes the amount which it is expected will be payable if such earnings are realized provided, of course, the assumptions as to the tax rates are disclosed.

8. In the preparation of statements which are designed to "give effect" to specified transactions, the provision for taxes may, depending on all the facts and circumstances, properly represent either (a) the actual taxes paid during the period adjusted to give effect to the specified transactions, or, (b) an estimate of the taxes that it is expected will be payable should the income of future years be equal in amount to the adjusted income shown in the statement. The statement should, of course, clearly show what the provision for taxes purports to represent.

I have felt it appropriate merely to outline our present feelings on this problem because I expect that ~~within the next few days~~ before long the Commission will release a full statement of its opinion in the matter. This statement will relate the facts of a fairly recent case involving this issue and will describe the various steps that were taken before the statement as finally amended became effective. It will also outline in some considerable detail the reasons underlying the Commission's views in the matter. For this reason, I shall not undertake here to develop the basis upon which our position rests.

The problems so far discussed have been largely concerned with the technical accounting foundations of the income statement. In the time remaining I want to open up the closely related question of whether, under present conditions, the details customarily given as to earnings data adequately meet the reasonable needs of investors and others for information about the operations of the business.

We may start with the first figure — sales. This is in most cases shown as one amount whether or not the company has lines that are distinct. Some few companies, prior to censorship restrictions, gave subdivisions of sales by lines of product. Some others gave data as to the quantity of different products sold during the period. These, however, were exceptions. In most instances there has been given merely the one, overall total — notwithstanding that in collateral literature companies often made much of their entrance into new fields or of the development and growth of some of their old lines. Such general non-quantitative information may be of distinctly limited usefulness, in contrast to a breakdown of sales into reasonable sub-categories.

The idea that it would be a step forward to have sales subdivided is not novel. It has long been standard practice for the railroad and utilities business; it has been used by some progressive industrial companies as a means of portraying to their stockholders the direction and amount of the company's growth. The present seems to me a specially appropriate time to consider this question, first because during the war period a good deal of experience was gained in the classification of sales for various purposes and, second, because of the substantial changes that are taking place in the business done by many companies. In examining the problem it must be realized, of course, that not all significant breakdowns are based on classification of sales by products. In appropriate cases, perhaps breakdowns according to methods of distribution or between domestic and foreign business would be more helpful. It must also be recognized that in some, perhaps many, instances it may not be possible to arrive at any truly significant subdivisions. But the challenge to make the income statement more useful in this regard still exists.

Consideration of the breakdown of the sales figure inevitably leads to the next basket figure so often found — the cost of sales item which accounts in many cases for 70% or more of all deductions from sales. Under our present rules this item may be given as a single amount although we do call for a supplementary schedule designed to reveal the amounts of such major costs as depreciation, taxes other than income taxes, maintenance, rents and management fees.

We have recently received a number of inquiries as to whether it would not be feasible and desirable to obtain some further sub-analysis of this item. These inquiries have suggested, among other things, the possibility of a subanalysis to show the aggregate amounts of such items as wages, materials and overhead. Some have asked not only for the amount of wages but also for a division between direct and indirect labor costs. Many of these inquiries appear to have as their objective the securing of data that might enable a rough determination of the possible effect of major changes in wage rates. Others may have in mind no more than an attempt to display visually the extent to which the company is vertically integrated. A few have suggested that the cost item ought to be subdivided — at least as far as possible — according to whatever breakdown is made of the sales figure, with a view to obtaining data not merely as to the volume of sales by lines but also as to the profitableness of various lines. Such suggestions, of course, encounter at least one very formidable obstacle — the problem of joint costs which some have said is all the more formidable because the statements involved now have to be certified.

I do not think it necessary before a group such as this to seek to appraise the usefulness of such additional data. Nor am I prepared to indicate any view as to how far such proposals are practicable, assuming their desirability. I introduce them to emphasize the existence of a rapidly growing feeling in many quarters that the content and detail of the income statement deserves reexamination and to suggest this as a timely and important area for further study.

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