

CONSOLIDATED FINANCIAL STATEMENTS

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QUESTIONS OF VALUATION

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A Discussion

prepared for the

"Arbeitskreis der Wirtschaftsprüfungs-
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by

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As I wrote to Dr. Reinhard Goerdeler, the sponsor of my appearance here, the Commissioners of the Securities and Exchange Commission are quite pleased that you have invited me to meet with you this afternoon to discuss the subject of consolidated financial statements and questions of valuation.^{1/} Both are subjects on which many volumes have been written, so I am interpreting the purpose of this meeting as intended to provide an opportunity for us to exchange ideas. For my part I will be interested in your explanations of the German Corporation Law, and I expect that you are interested in some of the problems we have faced at the SEC in the areas for discussion. I am especially pleased that I have this opportunity to repay the visit which some thirty of your group paid us following the Eighth International Congress of Accountants in New York in the fall of 1962.

In preparation for this visit I have benefited from Dr. Goerdeler's visits in Washington and from suggestions by Professor Kronstein and Mr. Klaus Pohle, who were in residence this spring at the Georgetown University Law Center. The technical papers presented by Dr. Herbert Rättsch and Mr. Johannes Semler, Jr., at the International Congress have been most helpful. In fact, for those who are familiar with these papers my discussion may appear to be a supplement to them.

Although the subject of auditing is not on our agenda today, but may emerge in the discussion, I think we can agree that the reliability

^{1/} The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

of the financial statements rests to a large extent on the adequacy of the record keeping, the degree of internal control, including internal audit, and the competence and professional standards of the independent public accountants. This much we can assume as a basis for our discussion.

Consolidated Financial Statements

A discussion of consolidated financial statements falls into two parts--policy matters and procedures or the mechanics of preparation and presentation. One of the first lessons the student of accounting learns with respect to consolidation is that it is misleading to include profitable subsidiaries in consolidation and to omit the unprofitable. Yet this was the very point at issue in a much publicized case recently which led to the adoption last month of an amendment to the SEC's proxy rules. This amended rule will require that the financial statements included in reports to stockholders of companies subject to the rule include consolidated financial statements of the issuer and its subsidiaries "if they are necessary to reflect adequately the financial position and results of operations of the issuer and its subsidiaries."^{2/}

The first edition of Montgomery's Auditing published in 1913 contains a chapter of ten pages on "Holding Companies." Most of this consists of quotations from a paper prepared by Montgomery's partner, William M. Lybrand, C.P.A., which was published in 1908. The chapter also contains a quotation from Ernest Reckitt, C.P.A., who was one of the founders of the profession in Illinois:

^{2/} Securities Exchange Act of 1934 Release No. 7324, May 26, 1964.

"I have in mind a case where I was called in to make, as I supposed, an audit of the books not only of the "Holding Company," but also of those of the subsidiary companies, and was amazed to find that it was proposed to have me audit only the "Holding Company's" books. Upon explaining that I could give no certificate on such audit, the most specious arguments were advanced and the president of the company attempted to use the full force of his strong personality to persuade me to defer to his wishes, which naturally only made me suspect still more the motives which actuated him. Finally, and with great reluctance, they handed me the books of the subsidiary companies, and I found out that two of the companies had made losses aggregating over \$200,000, no part of which losses had been taken care of on the books of the "Holding Company," though they had been careful to bring on to the books of the "Holding Company" the profits made by other subsidiary companies. One year later, the "Holding Company" and most of the subsidiary companies were in bankruptcy, as they deserved to be." 3/

So this principle of inclusion or exclusion has been with us for some time and should not require debate today.

The SEC's Regulation S-X, which governs the "Form and Content of Financial Statements" for most purposes under the acts administered by the Commission, states that "the registrant shall follow in the consolidated statements principles of inclusion or exclusion which will clearly exhibit the financial condition and results of operations of the registrant and its subsidiaries."^{4/} The rule qualifies this broad statement of policy by specifying that "the registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary" and that "due consideration shall be given to the propriety of consolidating with domestic corporations foreign subsidiaries whose operations are effected in terms of restricted foreign currencies."

3/ Montgomery, Robert H., "Auditing Theory and Practice," p. 558, The Ronald Press Company, New York, 1913.

4/ Rule 4-02.

The percentage-of-ownership question will be deferred for the moment. The latter point, as you may suspect, was considered by the Commission and the American Institute of Accountants (now American Institute of Certified Public Accountants) in 1939. The Institute's Accounting Research Bulletin No. 4 on "Foreign Operations and Foreign Exchange" was issued in December 1939 and revised in some particulars in 1953. The SEC issued an opinion of its Chief Accountant on January 4, 1940.^{5/} This opinion was a warning to registrants with the Commission to "consider carefully their policy with respect to the inclusion of such subsidiaries in consolidated financial statements." Since that time we have observed in practice and have recognized that the conditions which govern inclusion or exclusion of subsidiaries are subject to change from time to time as methods of doing business change, or because of outside factors such as political and economic conditions in foreign countries.

A recent example which came to our attention may be of interest. A registrant decided to exclude from consolidation its Latin American subsidiaries because it concluded that the earnings of these subsidiaries were not sufficiently reliable or accessible to be reported as earnings and earned surplus in reports to stockholders of the parent company. The fluctuating currency values, especially in those countries with multiple exchange rates, distort dollar figures to such an extent that their use for consolidating purposes was deemed to be unrealistic and misleading. Also some of the countries have proposed limiting dividend payments to a fixed percentage of local currency capital or net worth which will mean

^{5/} Accounting Series Release No. 11.

that substantial earnings would be included in a consolidated earnings report that may never be received as dividends by the parent company. The registrant also decided to exclude domestic insurance subsidiaries because they are now writing general insurance for the public in addition to providing the company's own fire and marine coverage, so that the insurance subsidiaries' business is now relatively unrelated to the company's processing and merchandising business.

Exclusion from consolidation of the Latin American subsidiaries, which are significant, involved problems of disclosing the effects of such procedure in relation to previously consolidated statements as well as problems of adequately reflecting the current position and operations of the company and its subsidiaries on a partially deconsolidated basis.

The company proposed to restate its prior year financial statements for comparative purposes and to reconcile the figures with those previously published when it issued financial statements on the new basis and to present separately the combined financial statements of the Latin American subsidiaries. Earnings to be reported by the parent would include only dividends received in U. S. dollars from income of the non-consolidated Latin American companies and the domestic insurance companies subsequent to their deconsolidation; any dividends received in dollars out of previously reported consolidated earnings or dividends received in foreign currencies and reinvested in the subsidiaries would not be reported as income but would be reflected directly in earned surplus of the parent. The remaining amount of the earned surplus prior to deconsolidation would be reported in a note to the financial statements.

The investments in the unconsolidated subsidiaries would be carried at original cost and the company's equity in the net assets and in the undistributed earnings of these subsidiaries would be set forth in notes to the financial statements. Explanation would also be made to the stockholders regarding the amount of the reduction in the previously reported consolidated net equity as a result of deconsolidating the subsidiaries and carrying the investments at original cost.

The company first effected the change in the semi-annual reports as of January 31, 1964, sent to the SEC and to stockholders. In addition to reflecting the appropriate adjustments in the statements (and restating the six months figures as of January 31, 1963, to a comparable basis), the company explained the changes in a narrative discussion in the report to stockholders. This is an example of a situation in which it was agreed that complete consolidation could be misleading as contrasted to the situation in which failure to make a complete consolidation was deemed misleading.

Accounting Research Bulletin No. 51, published in August 1959, is the most recent publication of the American Institute of Certified Public Accountants on the subject of consolidated financial statements. This document refers to material previously mentioned for guidance on foreign subsidiaries. Of the twenty-four paragraphs in the bulletin one ^{6/} states the purpose of consolidated statements consistent with the Commission's

^{6/} "The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with

rule. Four deal with policy and the remainder with what I have called procedure or mechanics.

As I understand it, German law requires full consolidation of all domestic subsidiaries owned fifty per cent or more. Here is a major point of difference between German and United States practice. Bulletin 51 says that:

"The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing toward consolidation."

On this point, as I have noted, our regulations say that "The registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary." We have encountered some unusual situations in which exemption from consolidation under this rule has been claimed but resisted by us. For example, one registrant attempted to deny control of a subsidiary by transferring ownership of the nominal capital to three employees under an option agreement by which the registrant could demand and acquire the shares which had a substantial equity at any time for a nominal consideration. The subsidiary had been created to take over substantial assets and related long term debt, thus eliminating the debt from the registrant's balance sheet. A supplemental consolidating statement including the new company was required in the prospectus.

Many companies, especially chain store operators, want to remove real estate and related debt from their balance sheets. Usually in these

6/ /continued/ one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies."

cases there is very little effect on the income statements. We have insisted that when subsidiaries are set up for this purpose such subsidiaries not be omitted from the consolidated statements. In one such case furniture and fixtures in the stores were transferred to such a subsidiary. A variation of the device just described was revealed in a recent prospectus. The registrant's interest in a large number of corporations which hold the real estate used by the registrant is represented by preferred stock, non-voting with respect to directors but convertible into common stock upon payment of a 10% premium after 90 days notice. Upon conversion the registrant would own in excess of 99% of the common stock of the real estate companies. At the date of the balance sheet in the prospectus, payment of the premium of less than \$100,000 would have increased the consolidated accumulated earnings by more than \$1,200,000. The solution to this problem was a three-column consolidating balance sheet showing the registrant and consolidated subsidiaries other than the real estate companies in one column, the combined real estate companies in the second column, and the combination of the two in a third giving effect to intercompany eliminations. I have injected some mechanics at this point to complete the example of a policy matter. Here the Institute's statement of policy is not as firm as we would have preferred.

In some cases we find banks and insurance companies included in consolidation in reports to stockholders. Our rules are quite specific. Banks may not be included in consolidation, but combined statements of banks which are majority-owned subsidiaries of the same person (usually a bank holding company) may be prepared with intercompany eliminations between the banks.

As to captive insurance companies, other than life insurance, our rules permit consolidation with a parent which is not an insurance company, investment company, or bank holding company when the principal business of the insurance company is the insuring of risks arising in the ordinary course of business of the top parent. Even when consolidation is permitted, separate statements of the insurance companies are required or group statements of companies of the same class. This situation is also common with finance companies. A related problem is alluded to in Bulletin 51. Many industrial and commercial companies organize finance companies to take over and finance the carrying of long term or instalment receivables. The bulletin says that separate statements for the finance companies may be preferable in this case. Usually when this is done the parent's equity in the earnings of the unconsolidated subsidiary is reported in the financial statements of the parent so that the earnings and stockholders' equity will be the same as though the subsidiaries were consolidated. Balance sheet ratios and detail in the income statements will differ from full consolidation. One of the committee members in assenting to the publication of the bulletin said that he believed "the consolidation policy section is deficient since it fails to restrict the increasing practice of not including certain subsidiaries in consolidated financial statements." This is a matter on which there is considerable difference of opinion in the United States.

Some companies organized vertically have urged that the subsidiary created to produce the raw material for the manufacturing plant should be omitted from consolidation. In the cases we have seen it has been

abundantly clear that the purpose was to remove debt from the balance sheet. Examples may be found in the paper industry where timberlands are transferred to a subsidiary and related debt of course follows. We have objected to the omission from consolidation of these companies in these cases. A somewhat similar effect, however, is accomplished when two processing companies create a subsidiary in which each has a half interest. Since neither parent has majority ownership, neither can include the subsidiary in consolidation under our rules and present practice in the United States. Bulletin 51 does not offer a solution to this problem. In these cases we have permitted each parent to reflect its interest in underlying earnings and equity in their financial statements. If these fifty-per cent owned companies and majority-owned subsidiaries properly omitted from consolidation are significant under our rules, separate financial statements or group statements must be furnished for them.

A difference in fiscal years is treated as a policy item in Bulletin 51. The point is made that such a difference does not justify exclusion from consolidation. Regulation S-X covers this in Rule 4-02 (b):

"If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all the following conditions exist: (1) Such difference is not more than 93 days; (2) the closing date of the subsidiary is expressly indicated; (3) the necessity for the use of different closing dates is briefly explained; and (4) any changes in the respective fiscal periods of the registrant and the subsidiary made during the period of report are clearly indicated, together with the manner of treatment."

This is often a problem when several companies are brought together for the first time.

Although I have injected some discussion of procedural matters in connection with consolidation policy, other topics deserve some attention. The question of the fifty-percent owned company requires further comment. I have cited the situation in which two parties create what might be aptly described as an incorporated joint venture. Some of these companies are operated on a breakeven basis while others accumulate earnings which may be paid to the parents in lump sums at irregular intervals. In such cases it appears that a better indication of the results of such ventures is for the parents to pick up their equity in earnings in each reporting period rather than reporting the dividends as income only when received.

I understand that in the not too distant past it was a practice in some international companies and an occasional U. S. company to prepare group accounts by including in the group accounts only the parent's percentage of all balance sheet and income statement items of the subsidiaries. By this method no minority interest would appear on the group statement. This is essentially what is done with joint ventures carried on in partnership form. We have had this idea advanced as a solution for the fifty-percent company problem and have accepted it in one case because of the most unusual circumstances which prevailed. It is not clear to me just how the problem would be handled under German law if my understanding is correct that a fifty-percent owned company must be included in consolidation. Does this assume that the other fifty percent is scattered so that the fifty-percent owner has undisputed control, or does it apply also to the situation I have described? If the latter,

do both parents include one hundred percent of all accounts and show a fifty percent outside interest? We have some situations in which both parties deny control. It should be mentioned that there is some reluctance to include companies in consolidation on the basis of a bare majority such as fifty-one percent, particularly when there is considerable debt or preferred stock outstanding in the subsidiary which might make realization of income from the common stock doubtful.

There are a number of technical points in the mechanics of consolidation which could be discussed. There is considerable literature available on the subject. No discussion would be complete, however, without some consideration of the debit and credit excesses which may arise in the elimination of intercompany investments.

A well-established rule is that the earned surplus or deficit of a purchased subsidiary at date of acquisition by the parent may not be included in consolidated earned surplus. Or, to put it more bluntly, accumulated earnings cannot be purchased and made available for dividends. The accounting which has been developed under the "pooling of interests" theory of business combinations is considered by some to be a violation of this principle of consolidation. If pooling accounting is accepted, it must be on the basis that has been advanced for the last twenty years at least that in a combination accomplished by an exchange of shares we have a continuation of both parties under a single entity and no change in accounting basis is necessary in contrast to a purchase for cash and debt in which a debit excess, commonly termed "goodwill," or a credit excess, in the past termed "negative goodwill" or capital surplus, arises.

In either case it is understood that these differences should represent remainders after proper allocation of the total excesses to other accounts to the extent justified by the facts.

In many cases this debit excess does not reflect a layman's notion of what is meant by the word "goodwill." Such readers of the balance sheet may think in terms of "the probability that the old customer will return to the old stand."^{7/} We have seen many situations in which promotional enterprises still in the development stage or companies with a record of losses have been acquired for a consideration which resulted in debit excesses in consolidation. In these cases a title such as "Intangible Assets, representing the excess of cost of investments in subsidiaries over net assets at dates of acquisition" with an indication in parentheses as to whether the item is being amortized would be appropriate. A recent prospectus^{8/} for a South African mining company still in the exploratory and development stage included a balance sheet of an operating subsidiary displaying a caption:

"INTANGIBLE ASSET:

Cost of control of subsidiary:
Excess of purchase price of shares acquired,
over book value of net assets"

It would be difficult to improve on this except to indicate the company's policy as to amortization. A note disclosed that the intangible was not being amortized.

^{7/} Couchman, Charles B., "The Balance-Sheet," p. 131, The Journal of Accountancy, Incorporated, New York, 1924.

^{8/} Palaboro Mining Company Limited, prospectus dated May 13, 1964.

It is hardly necessary to observe that goodwill should not be entered in the books merely to reflect management's opinion.

As to the remaining credit excess, Bulletin 51 says:

"In unusual circumstances there may be a remaining difference which it would be acceptable to show in a credit account, which ordinarily would be taken into income in future periods on a reasonable and systematic basis. A procedure sometimes followed in the past was to credit capital surplus with the amount of the excess; such a procedure is not now considered acceptable."

Two members of the committee of twenty-one were unhappy with this conclusion.

The disposition of the goodwill has been a subject for debate for many years. Current authoritative pronouncements on the subject prohibit the write-off of goodwill to earned surplus immediately after acquisition or to capital surplus.^{9/} Present accounting for poolings is considered by some accountants to be an evasion of these rules. Most businessmen, bankers in particular, seem to be allergic to goodwill as a sound balance sheet item. It is clear, however, that there is something seriously inconsistent in paying substantial sums for goodwill and then by the immediate write-off representing that it has no value. The classic comment on the subject was made by Couchman forty years ago--"To put it briefly, if you can write it down, you need not; if you cannot, you should! It is self evident that only in a profitable business can the element of goodwill be rightfully claimed to exist."^{10/}

^{9/} Accounting Research Bulletin No. 43, Ch. 5, par. 9, AIA, 1953; Accounting Series Release No. 50, SEC, 1945.

^{10/} Couchman, op. cit., p. 138.

A recent case demonstrates the difficulty of maintaining consistency and comparability on this subject. Within the past year the staff of the Commission in light of the situation in a particular case challenged the propriety of a registrant's continuing to carry goodwill on a balance sheet indefinitely and suggested that a program of amortization be adopted. This suggestion was not acceptable to the company and was not pressed by us in view of the representations made as to the plans of the company and proffered evidence of unlimited life. In less than a year's time, however, following some change in management, the company, supported by the same independent accountants, claimed that the goodwill had no value and should be written off in a proposed quasi-reorganization by which a substantial deficit augmented by the goodwill write-off would be charged to capital surplus created by the restatement of capital. This turn of events, because of the inconsistency, placed the staff in the position of demanding evidence to support the reversal of the accounting treatment it had previously questioned but accepted after discussion. Situations such as this suggest that a reasonable program of amortization of intangibles during the period of good earnings should be required in most cases despite optimistic beliefs that goodwill will last forever or increases in value rather than diminishes. Sprouse and Moonitz, too, in their accounting research study have trouble in working intangibles into a consistent theory and say that "these items are notoriously difficult to evaluate"^{11/}

^{11/} "A Tentative Set of Broad Accounting Principles for Business Enterprises," Accounting Research Study No. 3, p. 36, AICPA, 1962.

The pooling of interests solution of the problem avoids the creation of goodwill in consolidation as may be demonstrated by an example. With appropriate corporate action, A Company acquired all of the assets, properties and business and assumed all the liabilities of B Corporation in exchange for common stock in the ratio of one share of A for three shares of B. A shares are distributed to B stockholders, putting them in possession of 8% of A's voting stock. B continues as a division of A under B's administrative and operating management. B's president becomes a vice president and director of A. This situation clearly meets the pooling of interests tests of Accounting Research Bulletin No. 48, and the accounting on that basis was used in pro forma financial statements in proxy material.

As is fairly common in these situations, the financial press reported this as a \$25,000,000 transaction. If A had recorded this as a purchase using the market value of the stock as the price, an excess purchase price over underlying net assets of \$20,000,000 would have resulted. Assuming a ten-year amortization consistent with previous purchase transactions on the books of A, this would mean an annual charge to earnings of \$2,000,000 probably not deductible for tax purposes. This would be 12½% of the pro forma combined earnings and 250% of the earnings of B.

Suppose for some good reason B were to be the surviving corporation and the same exchange ratio applied. Such an assumption would produce something like \$200,000,000 in excess valuation or \$20,000,000 a year amortization which would be 120% of combined earnings and 125% of the earnings of A.

Some of the earlier accounting texts examined seem to say that current fair value should be applied to both A and B in this situation. This treatment would result in \$220,000,000 excess valuation which in a ten-year amortization would require 130% of combined pro forma earnings.

A recent study prepared for the Accounting Principles Board of the AICPA concludes that the pooling idea has gone too far.^{12/} The author takes the position that all combinations should be accounted for as purchases except in the rare situation in which it is difficult to say which party acquired the other. In such a case the author recommends what he calls a "fair value pooling" in which new current values are assigned to the accounts of both parties, but with the penalty that instead of carrying forward the combined earned surplus customary in a pooling, it is frozen and a new start is made. This is the position taken by those who urge that the quasi-reorganization concept applies to restatements upward as well as downward. This is an idea the SEC has not accepted as our position is that a quasi-reorganization is an informal substitute for a formal court reorganization which occurs in a distress situation.^{13/} It seems unlikely that the profession and businessmen will adopt the study's solution to this troublesome problem.

Questions of Valuation

The closing out of the discussion of consolidations with a consideration of accounting for goodwill provides an easy step to other questions

^{12/} Wyatt, Arthur R., "A Critical Study of Accounting for Business Combinations," Accounting Research Study No. 5, AICPA, 1963. See also McCarthy, George D., "Acquisitions and Mergers," The Ronald Press Company, New York, N. Y., 1963.

^{13/} See Accounting Series Release Nos. 15, 16, and 25.

of valuation. The term is broad enough to embrace liabilities as well as assets, and since the determination of income and stockholders' equity is dependent on the whole process we could survey all problems of fair presentation of financial condition and results of operations. I do not believe you intended to cover quite that much territory today.

As you know, the standard short form report issued by independent public accountants in the United States says that in their opinion the balance sheet and statement of income and retained earnings present fairly the financial position of the client company at the balance sheet date and the results of its operations for the period (usually a year) then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Indeed, the American Institute of Certified Public Accountants' code of professional ethics states, among other standards, that in expressing an opinion on representations in financial statements which he has examined, a member or an associate may be held guilty of an act discreditable to the profession if he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedures applicable in the circumstances. I am sure many of you are aware of the turmoil in accounting circles in the United States over the alternative accounting practices accepted under the cloak of general acceptance.

If I have understood the papers presented at the International Congress, our concepts and yours are not too far apart. There is one point which nearly every German visitor to my office raises, and that

is the subject of secret reserves! Usually it comes in the form of a question--Where are the secret reserves in financial statements of United States companies? If they are really secret, how do we know? I think it fair to say that where they exist you can point to the same places in both our countries--excessive provisions for depreciation, liberal interpretation of the distinction between maintenance charges and improvements to property, excessive provisions for losses on receivables and investments, liberal estimates of liabilities and excessive provisions for contingencies in the guise of actual liabilities. These are usually characteristics of the strong company. Most of our difficulties arise at the other end of the scale--failure to make a timely recognition of losses sustained on a project; overly optimistic appraisal of the collectibility of accounts, salability of merchandise, useful lives of assets, success in defending against claims for additional taxes and damages in legal actions; and so on.

Property, Plant and Equipment

Cost to the reporting company is the generally accepted basis. Determination of this cost is often in dispute. Cost when first dedicated to public use has been a development in our utility regulation--any excess of cost to the present owner is dealt with in separate accounts and regulations as to disposition. The measurement of depreciation or amortization of cost requires a treatise to explore the problem. To this we add the complication of differences in basis and differences in methods and rates for book and tax purposes. Problems in this area have been the subject of lively discussion in accounting and business circles in the United States, particularly in the last ten years.

The bases for determining depreciation, depletion, and amortization of fixed assets vary by industries and by companies within industries. Even in regulated utilities different methods have been approved by authorities having jurisdiction--both straightline and other methods have been accepted. Perhaps here more than in some other areas of accounting, managerial judgment, subject to critical review by independent accountants, is a significant factor. An assumption of precise comparability between companies may not be warranted, even though the methods followed appear to be the same, because of variations in amounts depending on whether the management is conservative or liberal in making provisions for depreciation and amortization. Recognition of this problem is found in Rules 3-12 and 3-20(c) of Regulation S-X which require disclosure of the basis of valuation, methods of depreciation, depletion and amortization, and of the related accounting for maintenance, repairs, renewals, and betterments as well as the method of accounting for properties retired or sold.

From time to time during the life of the Commission efforts have been made to induce us to accept appraisals of property as a basis for restating accounts. Often this effort comes from registrants with no record of earnings. In these cases the underwriters want a substantial-looking balance sheet. Enthusiasm for the write-up is dulled, however, when we point out that if depreciable property is written up this will require higher depreciation charges which will reduce the earnings or increase the losses reported.

The problem of reporting the financial effects of price-level changes has been under study for some time in the United States as in other countries. There are a few companies filing reports with the Commission which include limited supplemental disclosure of the effect of price-level changes as recommended in several of the studies that have been published. We have a number of filings by foreign companies in which the effect of price-level changes is reflected in the accounts. In these cases we ask for a reconciliation to eliminate the effect of such accounting or, if this is impossible as when adjusted depreciation charges are carried into inventory, an explanation. I have observed that there is no uniformity in practice in these companies. This is also characteristic of the writing that has been done. One well-known company records additional depreciation to reflect the cost of replacement but keeps its assets stated at cost, while another adjusts both assets and depreciation charges. Then there is the problem of a general index of prices or specific indices by classes of property. Some of the confusion stems from a lack of agreement over what is intended to be accomplished--provision for replacement or a measurement of depreciation of existing property in terms of current price levels. The latter approach seems to be gaining the ascendancy in the United States ^{14/} but it has not yet acquired the status of a generally accepted accounting principle.

^{14/} See "Reporting the Financial Effects of Price-Level Changes," Accounting Research Study No. 6, AICPA, 1963.

Inventories

Inventories are a continuing source of trouble for us both from the accounting and auditing standpoints. It is readily recognized that a single method of valuation is not suitable for all industries or for all companies within the same industry. The best known alternatives perhaps are "first in, first out" (fifo) and "last in, first out" (lifo). It took some time and litigation for the latter to be widely accepted for income tax purposes. This method affords a tax benefit but one of the conditions of its use is that the lifo inventory be reflected in the books. As the use of lifo was extended it attained the status of general acceptance while fifo retained that status.

Consistent application of either method is considered appropriate in reporting the results of operations. Failure to disclose the method used deprives the investor of significant information; hence, Rule 5-02-6 (b) of Regulation S-X requires the disclosure. Continued use of lifo in periods of rising price levels results in an increasingly conservative valuation of the inventory in the balance sheet which analysts should recognize when making comparisons between companies which have adopted lifo at widely different times or between lifo and fifo companies. The accounting staff of the Commission and some public accountants encourage companies using lifo to disclose in footnotes the inventory values on a current basis.^{15/}

^{15/} For an extended discussion of inventories see Hoffman, Raymond A., "Inventories," The Ronald Press Company, New York, N. Y., 1962.

Investments in Subsidiaries and Affiliates

The discussion of consolidations covered some of the questions that arise in the valuation of investments in subsidiaries and affiliates. A useful reference for information as to practice in the United States on this point and many others is the AICPA's annual survey of the accounting aspects of the annual reports of 600 industrial and commercial corporations published under the title "Accounting Trends and Techniques." The seventeenth survey covers reports for fiscal years ending within the calendar year 1962.

Table 21 in this survey summarizes the bases of valuation of unconsolidated subsidiary and affiliated companies. In both categories cost predominates as the basis but the table shows an increasing use of "cost plus accumulated earnings or equity in earnings" and "equity in net assets." This may reflect the influence of Accounting Research Bulletin No. 51 in which we find with respect to unconsolidated subsidiaries in consolidated statements (the bulletin is silent on this point in parent statements) that:

"The preferable method, in the view of the committee, is to adjust the investment through income currently to take up the share of the controlling company or companies in the subsidiaries' net income or net loss, except where the subsidiary was excluded because of exchange restrictions or other reasons which raise the question of whether the increase in equity has accrued to the credit of the group."

Research and Development Costs

In the post-World War II period proper accounting for the vast expenditures on research and development has been a highly significant factor in the financial reporting of many companies. Two principal

methods of accounting are generally accepted. It is common practice for large, well-established companies to expense such outlays as they are incurred on the theory that this is a regularly recurring cost of maintaining the position of the company in its industry.

New companies organized to develop and exploit new products are more prone to capitalize these costs and amortize them as the product is produced and sold. However, when failure of the project is evident the loss must be recognized.

An intermediate position can be sustained for the company which maintains a research staff and allocates part of its cost to specific ventures and the remainder as current expense for sustaining the activity.

It is clear that the propriety of any of these methods depends upon the facts. The Commission's practice in this area is to make appropriate inquiries, challenge the method of accounting if this seems necessary, and to require pertinent disclosure of the company's policy. It is believed that this practice provides the necessary information for the protection of investors.

Costs of research and development are only one class of deferred charges which at times prove troublesome in preparing financial statements. For example, should heavy advertising expenditures be written off as incurred or should they be deferred and amortized against revenues deemed to have been derived from the promotional effort? The insurance industry, which is regulated by state commissions in the United States largely in the interest of policy holders rather than for investors, demonstrates the problem in an exaggerated form. Under state regulation costs of

obtaining new business must be treated as expense as incurred whereas the policy premiums must be deferred and taken into income with the passage of time. This has the effect in a growing business of appearing to be less profitable than a stagnant one living off its earlier efforts. In filings with the SEC a reconciliation to generally accepted methods of accrual accounting is required for fire and casualty companies.

Pensions

Accounting for pensions can serve as one example in which the determination of the liability for balance sheet purposes presents difficult problems upon which agreement is lacking in the United States.

The variety of plans in this area and the many factors that enter into the determination of the amounts involved make uniformity among companies and even consistency in application year by year in the same company difficult to attain. Various aspects of the problem have been dealt with by the Commission from the earliest days, and the AICPA has issued statements for the guidance of the profession. Differences in accounting result from the methods of providing for past service costs and for current costs of accruing pensions not yet vested. These problems are currently under study by the research staff of the AICPA and by our staff. SEC disclosure requirements as to pensions are specified in Rule 3-19 (e) of Regulation S-X.

CONCLUSION

The foregoing should serve as a basis for discussion to which, if time permits, may be added any other topics of interest to members of the Working Group.