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SOME OBSERVATIONS ON THE RELATION

BETWEEN FINANCIAL AND TAX

ACCOUNTING PRACTICES

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SOME OBSERVATIONS ON THE RELATION BETWEEN FINANCIAL AND TAX ACCOUNTING PRACTICES

Those who discuss the subject of tax accounting and financial accounting [1] are wont to dwell on, and inveigh against, selected differences between the two systems. That is natural. Such a discussion can be made much more colorful and invites argument. However, partisanship in such arguments is not too unlike the fictional leopard — it seems to change its spots according to circumstances. Since I have to deal mostly with financial accounting, it is usually in discussions of questions in that field that I hear about tax accounting. Strangely enough — or perhaps not so strangely — I am told quite often that a particular accounting method cannot be followed because it would not be acceptable for tax purposes and that to insist upon its use would mean that two sets of books (in addition, of course, to cost records and other interpretative records) would have to be kept. On the contrary, when a proposal is made to require in financial accounts the use of a method or of amounts accepted for tax purposes, I am frequently told that the method or amount in question is one of those things you have to do or use for tax purposes, but is not, of course, the sort of thing that can be used in financial accounts. To a greater or less extent we are all guilty of thus picking and

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1/ I shall use the term "financial accounting" as a shorthand way of referring to the body of accounting principles and methods followed in presenting financial statements to stockholders and investors.

choosing our "authorities". Certainly I have cited tax accounting requirements as support in numerous discussions and have denied their relevancy in other fields.

To obtain a proper perspective of the relation between tax and financial accounting, it is necessary at the outset to recognize that the two fields are perhaps 80% or maybe 90% consistent. That area of similarity is in the long run a good deal more important than the remainder in which practice is not consistent. It gives ground for hope that the area of dissimilarity can be narrowed. It invites also the conclusion that many of the differences are the direct result of essentially different objectives and problems in the two fields. If that conclusion is sound, and I think it is, no satisfactory appraisal of differences can be made and no logical recommendations for eliminating differences can be arrived at without a rather careful determination of just what those differences are. As accountants, you are well aware of the fundamental goal of financial accounts — the presentation of a fair and informative report, businesswise, on the condition of the business and the results of its operations. The other speaker tonight, Mr. Tarleau, is far more competent than I to explore the objectives and problems of tax accounting. Nevertheless, I would like to call attention to one or two things which, in my judgment, do account for (and justify) many of the differences between the two systems.

The power to tax income from whatever source derived as set forth in the 16th amendment is broad, leaving to the legislative branch the decision whether to tax all income alike or whether to tax different forms of income in different ways or at different rates. The Congress may also determine whether to tax all of the income from a particular source as such or whether to permit the making of certain deductions therefrom. As is evident from the most casual reading of the tax code, all of these prerogatives have been exercised by the Congress. Dividends received by corporations, for example, are taxed differently from their operating revenues. Deductible items are specified at times in general terms; in other instances in very specific language. Certain categories of expenditures — charitable items for example, or political contributions — are permissible deductions only in limited amounts or not at all. Special forms of deductions quite unrelated to any tenets or principles of accounting are sometimes authorized for particular industries, as, for example, percentage depletion. The impact of the tax law is sometimes softened by special forms of relief provisions in an effort to do equity in meritorious cases. In other instances, the privilege of deduction for tax purposes is withheld where the expenditure in question is repugnant to public policy. Also, by virtue of changes in tax rates, or even in methods of taxing, in accordance with the need for revenue, a very great emphasis is laid upon the time when items are deductible — deduction in one period rather than another (even with the benefit of existing carry backs and carry forwards) may result in wholly dissimilar tax effects depending on the relative levels of income and of taxes. Finally, it is apparent that in the drafting and interpretation of tax statutes, neither Congress nor those who advocate particular tax provisions have felt obliged to exclude from consideration broad matters of public policy and national economic health with the result that the tax law is often so drafted as to encourage certain types of activity and to discourage others. I have no desire nor would it be appropriate for me to seek to put in issue the merits of such policies. I only point out that they are points of view or considerations which may and often do necessitate or at least result in tax requirements that are different from those generally agreed upon as appropriate for financial purposes.

In contrast to these considerations involved in revenue bills, financial accounting is primarily designed to report what happened when it happened. Expenditures that have resulted in no benefit or the benefit from which has been received are no less a charge against current revenue because they may have been improper or illegal or not a "necessary business expense". It is not for accounting to accord them different treatment than other expenses, except in the matter of classification or in the recognition of possible rights of action against those responsible for the expenditure.

A second major contrast springs from practical considerations, partially due to fluctuating tax rates. It is apparent that to permit tax deductions on the basis of conjecture as to possible future expenses or losses unsupported even by broad experience ratios or other data on like transactions of the business in the past, would enable unwarranted shifting of "expenses" and "losses" into high tax and profit years and out of low tax and profit years. Hence, it is generally true that losses and expenses are ordinarily recognized only upon the basis of an external event such as a sale or its equivalent. For financial purposes, on the other hand, there is every reason to attempt a fair approximation of slowly accruing losses and expenses long before they have been absolutely and finally determined. This point of view has been firmly expressed by the Commission in various cases, of which the best ~~know~~ known is perhaps the Associated Gas and Electric opinion. It may be pointed out, too, that even with benefit of the carry-back, carry-forward provisions taxation is still fundamentally a periodic affair so that losses and profits of different years are not fully offset. Financial accounting on the other hand is a continuous process so that the losses of one year are offset against the profits of another through the permanent equity accounts. That offsetting process is interrupted only by the disposition or perhaps reorganization of the business.

In one respect the development of tax accounting principles has a great advantage, ~~the product of which is not always fully utilized in deliberations on the merits of financial accounting practices.~~ By its nature tax accounting requires a rather comprehensive and detailed set of rules, regulations, published interpretations and opinions. In addition there are embodied in tax procedure well established means for placing disputed issues before the appropriate tribunals for final decisions. More important, the interests of the parties, in terms of dollars and cents, are so immediate and important that the courts, including the Supreme Court, have had innumerable opportunities to decide, and to discuss in their opinions, those issues which are controversial. In contrast, the instances in which matters of financial accounting have come before the courts are rare, indeed. However, the considered opinions rendered in tax cases are a valuable part of the discussion of financial accounting questions, a part that has not, I think, been fully utilized in deliberations over the merits of financial accounting practices. Such decisions must, of course, be approached with some caution to determine whether the decision in the particular case was founded on special considerations of the revenue, not germane to financial accounts, such as those I have mentioned earlier. To all those who view accounting as a series of conventions devoid of and unrelated to any fundamental principles comparable to, let us say, the law of gravity, such court decisions must be controlling — at least under our law that is the traditional method of settling disputes on the facts or on the interpretation to be accorded social and business conduct. To those who ascribe to accounting principles something more than the status of conventions, perhaps a status akin to economic principles, the opinions of the courts must nevertheless stand as authorities not lightly to be disregarded.

The fact that there are differences between the tax and financial accounting practices of a particular company is itself a fact that must be given due consideration in the preparation of the financial statements. Much attention has been given to this problem in recent years by all interested in accounting matters — and some curious and novel solutions have been proffered. In some respects, at least, the existence of the problem is due to a refusal or failure on the part of financial accounting to accept one of the principles of tax accounting. I have in mind the question of surplus charges versus income charges. Under tax practice one deducts from <u>all</u> of the taxable income <u>all</u> of the deductible items — the balance being net taxable income. In financial practice some are inclined to undertake to arrive at some estimate of what might be termed "but for" profits — that is, what the net income would have been "but for" the fact that some fixed assets were sold at a loss, or some bonds were refunded or some payments made to inaugurate a pension plan, or some additional taxes were levied. The "but fors" are either put in a separate section of the income statement or tucked away in a statement of surplus. And so a problem is created. The "but for" income is not what is taxable — and the taxes paid or to be paid are thus not in the expected ratio to the reported income. And so we find a mechanism developed which either charges the "but for" income with "but for" taxes or else, leaving taxes "as is", charges the income with so much of the items carried to surplus as is necessary (when added to the taxes payable) to arrive at the "but for" income less the "but for" taxes. Tonight is not the time to discuss the merits of this particular controversy since it is little more than an interesting side issue to the main topic — financial versus tax accounting. It may be observed, however, that an attempt to arrive at "regular" or "normal" or "expected" earnings is considered by many to be a function of financial analysis rather than of accounting — though perhaps it is something best done by accountants. At all events, the manner in which I have presented the issue may perhaps serve to indicate my own view, which I think is also that favored by the Commission.

Occasionally, the effect of tax accounting is such as to pose very substantial and difficult problems to the financial accountant. I will cite two cases, one actual and one potential. In a recent case a company had acquired all of the outstanding stock of a closely-held company for, let us say, $1,000,000 cash. Immediately on acquisition the new subsidiary declared and paid to its new parent a cash dividend of $1,000,000, leaving it with net assets of about $1,000,000. Of these only about half were long term fixed assets whose worth might be said to be subject to some — though in the particular case apparently not much — uncertainty. The reason given for such a transaction was that by this means the vendor stockholders would have a capital gain for tax purposes whereas had they sought to obtain the accumulated profits of the company directly they would have been treated as ordinary taxable income and would have been taxable at very high rates. But to the financial accountant the question was, should the stock be carried in the accounts of the new parent at zero (cost $1,000,000, less a $1,000,000 dividend paid from acquired surplus) even though the subsidiary had sound assets after the dividend of $1,000,000. On the facts of the particular case a statement was accepted in which the stock after the dividend was carried at approximately $1,000,000.

The potential case will be far more widespread. Many companies engaged in war work will find themselves in the postwar period with two plants, only one of which can be used. One of these will be the prewar plant, relatively obsolescent and uneconomical but carried in the accounts at depreciated cost. The other will be a modern and efficient plant erected for war work and carried at zero -- since it was amortized for both tax and financial purposes at 20% per year because it had qualified as an emergency facility under Sec. 124 of the tax law. If the old plant is scrapped or sold, as seems most likely, we are left with the perplexing question of whether the company should thenceforth reflect no plant in its statements and report its income without any depreciation charge. Or should the remaining plant be "written up" to its apparent value, contrary to what is generally accepted as sound accounting practice, to show assets at cost less depreciation.

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There is ample evidence that tax accounting requirements and decisions have had a direct influence on financial accounting practice. I do not refer at this late date to the changes brought about at the time income taxation was begun, but to its present influence on current questions. In general, this influence takes two forms — one, determinations made as to factual questions; the other, determinations as to matters involving broad questions of accounting theory. Perhaps the best example in the latter group is a final determination that under the 16th Amendment something is or is not income — as was the case in the Eisner v. Macomber and related decisions. In view of the language of the 16th Amendment, that decision would seem to be fully binding on accountants.

There are many examples in the other category. It is not at all uncommon in filings with the Commission to encounter adjustments that are made to bring the books into agreement with Treasury or court decisions as to depreciation provisions, bad debt allowances and so on. On the other hand, particularly in the utility field, companies used pretty consistently to take a good deal more depreciation for tax purposes than they would admit should be taken for financial purposes. In more recent years, through the efforts of regulatory agencies and as the inadequacy of reserves accumulated for financial purposes became more and more evident and so easily demonstrated, there has been a widespread tendency to increase the annual financial charge for depreciation to about the same figure as is taken for tax purposes.

One tax accounting practice that has been questioned from the financial accounting viewpoint is the use of the so-called specific certificate method of determining gain or loss on the disposition of securities. The question becomes particularly acute in the field of investment companies where reported results may be materially different depending on whether the specific certificate method or some other method is used. Securities of a given class or series are identical in all their legal rights or privileges and consequently they should, in my opinion, ordinarily be handled as a fungible group for which an average cost procedure is most appropriate. The erratic results that can be achieved under the specific certificate method seem to me wholly at odds with the homogeneous nature of a block of securities and with the principles of financial accounting. Certainly, the specific certificate philosophy is not the customary approach in accounting for other fungible goods. Nevertheless, the special tax laws applicable to investment companies are of such importance in the financial affairs of the company and in the payment of dividends that to date we have not insisted upon the use of average cost in the presentation of financial statements of such companies except by way of explanation.

In some problems it is difficult to determine which system has affected the other. This seems to be the case with the LIFO inventory method.

While it first appeared, I believe, in financial accounting practice, it was there limited to a relatively few kinds of companies. After some effort its use was permitted for tax purposes to a few carefully restricted types of companies. More recently, a change in the tax requirements to permit its much wider use has resulted in its adoption in a wide variety of kinds of business where theretofore that method was not considered at all applicable. It is, of course, to be desired that companies will employ a method of inventory accounting that will fairly and reasonably measure the balance of the inventory at the year-end as well as the cost of goods sold during the year. Since the standards for determining whether LIFO is an appropriate method for a particular company have not yet been clearly and firmly formulated, the Commission has been slow to object where companies have changed to this method. However, it is to be presumed that companies who shift to the method have made a firm decision that will not be casually altered.

There is a recent illustration of how the ideas of accountants — particularly financial accountants — have influenced tax requirements. Under a recent Treasury ruling the profit on war contracts terminated for the convenience of the Government is in most cases taxable in the year of termination rather than of settlement. While the point may not have been beyond dispute, it seemed to be the consensus prior to the above ruling that such profit was taxable in the year of settlement.

For financial purposes such treatment seemed unsound in that it made the realization of profit related primarily to the expedition with which a claim was pressed and to the possibility of delay in obtaining necessary Government approval rather than to the work done for which the profit was paid. These considerations were urged by many accountants directly and through the professional societies. The ruling is, I think, due in no small part to their efforts.

To summarize: As I see it, the propriety or soundness of a financial accounting practice — that is, one followed in preparing financial statements for use by stockholders and investors — should be judged not by whether it is generally accepted by accountants or required for certain purposes by Governmental bodies, but according to the reasonableness of the result it achieves in portraying realistically the financial affairs of the company. Under this standard the Commission has repeatedly held that accounting principles that are unsound cannot be made proper by a vote of stockholders, a resolution of a board of directors, or the provisions of the charter or an indenture.

The fact that a particular practice is widespread or is supported by individual accountants and accounting organizations, or is required for a particular purpose is obviously important and often controlling. But in the end, an accounting practice or principle is no sounder than the reasoning on which it is based.

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