# SOME CURRENT ACCOUNTING PROBLEMS

Address by

Earle C. King

Chief Accountant, Securities and Exchange Commission

Before the

22nd Michigan Annual Accounting Conference

Ann Arbor, Michigan

Saturday, November 15, 1947

Four years ago, my predecessor, Mr. William W. Werntz, spoke before this body at its meeting in Detroit on the timely topic of Current Accounting Problems. Two years ago, at your meeting here in Ann Arbor Mr. Werntz' subject was Trends in Accounting. And now we have distilled the subject slightly by calling its Some Current Accounting Problems.

In reviewing these earlier papers I find that in 1943, the middle of the war period, we were concerned with the effects of serious shortages in personnel on the work of public accountants, problems of accounting immediately related to the war, such as investments in enemy occupied countries or in the combat zone, contract renegotiation and termination, war and postwar reserves, the impact of the high tax rates on accounting and especially financial reporting and to a limited extent with the perennial problems of the form of the income statement and accounting for capital stock and surplus.

With the end of the war we find that in 1945 there was a reanimation of the debate over the purpose and hence the form and content of the income statement and the related problem of charges and credits to surplus. Studies made and reported upon at that time indicated that practice in these fields was 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. At that time too, and for at least the following year, we were concerned with the disposition of war and postwar reserves and the allocation of expenses allegedly related to the war or reconversion to peacetime operations. The treatment of so-called "tax savings" was also the subject of active discussion leading to somewhat conflicting solutions by the American Institute of Accountants and the Commission.

This glance over our shoulders seems to indicate that <u>some</u> of the problems discussed two and four years ago are still current. To these have been added problems that may appear to be new to some people but to others may be only a renewal of interest in problems of other decades.

Renewed efforts have been applied to one of the problems of long standing – the historical or "all-inclusive" income statement versus the earning power or "current operating performance" concept. Reports I have received of the deliberations of the American Accounting Association last September indicate that no retraction is contemplated in the position taken on this subject in their statement of Accounting Principles Underlying Corporate Financial Statements. The Association's statement of the historical concept as applied to the income account was expressed in 1941 as follows:

> "Income is measured by matching revenues realized against costs consumed or expired, in accordance with the cost principle. All such revenues and costs should be reflected in the income statement. Only in this manner can the income statements of a corporation express completely its entire income history for a period of years. For any one year the income statement should reflect all realized revenues, and all costs and losses written off during that year, whether or not they have resulted from ordinary operations."

In contrast, a bulletin now under consideration by the Committee on Accounting Procedure of the American Institute of Accountants dealing with Income and Earned Surplus recognizes the conflicting opinions on the subject and, although not as unequivocal as the statement of the American Accounting Association just quoted, in effect supports the opposite position or earning power – current operating performance concept since certain specified extraordinary items are required to be excluded from the determination of net income for the year if their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom.

This apparently irreconcilable divergence of views between the spokesmen for the American Accounting Association and the American Institute of Accountants on a question of accounting of such fundamental importance is most disturbing to me; for it is to such bodies of professional accountants that the Commission looks for the authoritative statement of accounting principles which may be regarded as generally accepted.

While the accounting staff of the Commission has been, for many years, fully in accord with the views of the Association as quoted above and has lent its support to their general adoption, in view of the widespread disagreement on the subject among practicing public accountants and the convincing arguments advanced in support of both sides of this question we have not felt it desirable to freeze our views by recommending to the Commission the adoption of a rule on the subject. Instead it seems desirable to observe the effects of the proposed bulletin (if it is issued in its current form) in practice for a reasonable period, and in the meantime to accept either treatment offered on the grounds that each has substantial authoritative support. It may be that, as some of the proponents of the proposed bulletin intimate, supportable entries direct to surplus will be so rare under the provisions of the bulletin that the results will be acceptable. If this proves to be the case, it will be a long step forward in the development of comparable profit and loss statements; for analyses we have made have indicated a lack of uniformity in this field between industries, companies in the same industry, and clients of the same accountants.

A public accountant friend of mine has proposed another solution to the problem which warrants serious consideration. His proposal is that in publishing corporation annual reports the management should recognize that the financial press and investors treat the reports as in the nature of periodic prospectuses, and since this is so, at least three years' profit and loss statements should be included as is required for a prospectus under the Securities Act of 1933. In applying this procedure the proposal contemplates that each year the accounts of the preceding two years included in the report would be recast if necessary to give effect to charges and credits in earned surplus during the current year falling within the acceptable standards of the proposed accounting procedure bulletin. Such a procedure would be similar to the restatements necessary in preparing the three years' profit and loss statements and the earnings summaries included in 1933 Act registration statements and prospectuses. Such statements normally are not annual occurrences with most corporations. Despite the obvious merits of this suggestion I am somewhat fearful that annual recasting of profit and loss statements for reports to stockholders would not increase the confidence in which accountants are now held – particularly if the results of recent public opinion polls are to be given any weight.

My own thoughts in the matter are influenced by a belief that if we can reach a general acceptance of the view that all elements of profit or loss recognized during the period must be included in the profit and loss statement for the period, thus banning any debits and credits to earned surplus for these items, we will attain a more carefully considered periodic report than under the other procedure which permits correction of this year's errors – particularly errors in judgment – to be reported through earned surplus in subsequent years. The many corporate actions that follow from the year's determination of income, such as bonus and dividend payments, compliance with terms of contracts and indentures and so on, are additional reasons for adhering to the historical or all-inclusive profit and loss statement. It is contended that exceptions are inevitable in the application of this method. Lump-sum write-off of goodwill or other intangibles is given as a common example. If the problem is faced squarely, I think a sound program of amortization through profit and loss can be developed to cover these cases and thus avoid the lump-sum treatment. The problem of over-generous provisions for losses through excessive charges to profit and loss can be meet by more careful determination of the appropriate amounts to be considered in the determination of income and the expression of conservatism through appropriation of surplus to general contingency reserves or by recognizing that earned surplus is in fact an all-purpose reserve to be guarded by conservative financial management. Such a program, I sincerely believe, would retain for the accountants the confidence of investors and other users of financial statements more surely than a program which would permit the annual revision of published profit and loss statements.

Some of our difficulties with profit and loss or income statements result from a growing tendency to avoid describing the intermediate and final balances. A sampling of income statements for fifty representative corporations revealed that forty companies concluded their statements for 1936 and 1946 with a caption of "net income" or its equivalent. Six companies which had used the term "net income" in 1936 used some indefinite series of concluding captions in 1946 with the result that the amount of "net income" was not clearly indicated. Three companies which had used the indecisive style in 1936 used the term "net income" in 1946 and one company avoided coming to a definite conclusion in both years. This trend, I fear, will be accelerated if it becomes accepted procedure to exclude certain designated types of items from the determination of net income.

A recent registration statement contained an excellent example of the situation described. The consolidated profit and loss statement followed generally a normal arrangement except for the deduction of minority interests in profits before a series of debits and credits relating to inventory reserves and commitments and the omission of descriptive or identifying captions for any intermediate balance in the statement. No balance was labelled "Net Profit" or "Net Income" or "Income for the Year." When asked what the net income was, the certifying accountant answered that it was debatable and by omitting captions the reader could decide for himself. It seems to me that it is the primary responsibility of the management to determine a net income figure and so label it in any profit and loss statement intended for public use. The accountant in his certificate commits himself as to the fairness of the management's determination. To correct this situation we required a rearrangement of the statement and a proper description of intermediate and final balances to indicate clearly that the debits and credits relating to inventory reserves and commitments were considered by the management and the accountants as affecting the current year's profit and were not provisions for losses assignable to future years. In this connection it was necessary to revise the footnote describing the basis of inventory valuation to indicate the relationship of the reserves to the inventory methods employed.

Published financial statements have been attacked at another point during the past year. Stories by financial writers have been introduced by such titles or headlines as "Phantom Profits Worry Foresighted Managements – Stockholders Must Be Taught To See Red Ink Through the Black" and "Big Increase Seen in Industry Profits – One-Third of Profits 'Only on the Book.'" The text of one of these stories refers to "baloney dollars" and states that if standard corporate accounting is followed stockholders are given a false picture of the corporation's current activities. Another article asserts that it should be understood that more than one-third of the reported profits are not real earnings but book profits. These articles in the language in which they are written have an inevitable tendency to discredit generally accepted accounting procedures, the good faith of responsible corporate officials, the competence of the independent accountants and the safeguards afforded by a Securities Act which outlaws misleading financial statements. Briefly, if the financial statements now in current use present a false picture we must reexamine our principles.

These comments, of course, have been precipitated by a recognition on the part of the authors that changing price levels must be considered when interpreting financial data. Current criticism is directed at only two elements – inventories and depreciation. More comprehensive treatment of the subject could be made to include other assets and liabilities with varying degrees of influence on the result. In any event, the current discussion will be recognized as a renewal of one which has cropped up from time to time even since accounting had its beginnings. Few if any of the current attacks have any basic newness.

As to the first subject, inventories, it is maintained that when low cost inventories are disposed of and replaced in a period of rising prices a fictitious profit is shown if there is no increase in the physical volume of the inventory. Conceding the economic point that is being made, I dissent from the implication of deliberately false representation that is conveyed by the use of the term “fictitious.” The economic concept has not been developed and reduced to such a satisfactory basis for accounting measurement as would warrant the abandonment of the cost basis. I think that no one will take exception to the idea that management must be guided by the influence of changing price levels in buying, selling, inventory control and disposition of profit. To the extent that increased profits are correlated with greater demands for working capital their distribution in dividends must be avoided or, as an alternative, additional working capital obtained from other sources. If the creation of reserves in anticipation of future price declines will assist in convincing stockholders and other interested parties that profits must be retained in the business, certainly the directors are justified in creating such reserves – but not as a factor in determining net income. The creation preferably should be by appropriation from earned surplus and the subsequent elimination by return to earned surplus. The American Institute of Accountants has just published an accounting research bulleting (No. 31) covering this problem along the lines I have indicated.

With regard to the second subject, I had thought until recently that depreciation accounting had come to be well understood by business men as well as accountants as a procedure whereby the cost of productive facilities was allocated as equitably as practicable over the period of usefulness of the facilities. That the cost of replacement of the facilities at some future date had no bearing on the accounting for the assets currently in use, I also thought was generally acknowledged. Current departures from those concepts have been in two directions with some companies torn between the two. Some corporations engaged in a plant expansion program today claim that current costs are excessive and their incurrence is justified only because of the high volume of business anticipated for a short period prior to an expected recession. While a proper marshalling of facts might support extra depreciation charges in the early years of production under the conditions described, accepted methods of calculating depreciation exist now to meet this situation.

The other approach is taken by corporations with substantial low cost plants in use which it is expected may be replaced some time in the future at price levels higher than cost. This theory is expressed in the accounts by charging depreciation on cost increased by some arbitrary percentage to reflect the assumed replacement price level. Failure to apply this procedure, some financial writers say, results in inadequate depreciation charges and a corresponding overstatement of profits. One prominent newspaper published an article in which this point of view was expressed only ten days after the same paper reported the action of the American Institute of Accountants' Accounting Procedure Committee under the headline "Accountants See Error in Charges – Depreciation Cost Should Not Be Levied on Income, Says Procedure Committee." Despite this somewhat misleading introduction the paper gave a fair summary of the Committee's most timely, and, it is to be hoped, effective release. The press release, as most of you are undoubtedly aware, emphasized the belief that "accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level." This leaves determination of a stabilized price level a bridge to be crossed when we come to it, but in the meantime depreciation on cost is to prevail.

It should be noted that the Committee indicated that current proposals adopted by some companies were inconsistent in that the charges for depreciation based on higher price levels were included in the income account whereas the carrying values of the assets were not revalued to conform. The emphasis today in corporate reporting is on minimizing profit whereas in our last period of high price levels – the 1920's – the desire appeared to be to inflate the assets by means of appraisals while continuing depreciation on cost and thus not adversely affecting profits. In the 1920's it was a not uncommon view that the balance sheet should show current values; however, it was the general view that profit could only be determined by matching expired actual costs with revenues.

There seems to be much greater diversity in the depreciation situation than on the inventory question. The substitution of any procedure for the cost basis of accounting involves long range forecasting of the crystal-ball variety. Such forecasting must consider the trend in the price level, changes in demand for products and changes in production processes. Presumably the business man who expands his plant at today's prices believes he can recover his cost during the life of the facilities in competition with older but lower cost plants. Improved efficiency or a better product, among other factors, must have something to do with the decision to take the risk. Application of either the appraisal or index number procedure to adjust for changing price levels, if applied uniformly by industries or to all business, would put the measurement of depreciation on the same footing but would not allow for differences in maintenance costs and productive efficiency – vital factors which cannot be ignored. It is a prominent misconception in much of the discussion appearing in the press that these procedures as well as the cost basis are directly related to replacement of facilities. Exact replacement is rarely made and in many cases substitute products eliminate the present producer entirely.

I think it is important to note that some of the current discussions of the problem are along the lines of generally accepted accounting principles and indicate that the majority of banking and business leaders adhere to the professional accountants' position. For example, an article published by a large New York bank surveying current practices states that "From the accounting standpoint, it is questionable whether the charging of depreciation on the basis of original cost can be properly termed under depreciation," and concludes that, "These questions of accounting procedure are of more theoretical than practical importance. From the point of view of management, the problem is primarily one of finance. Whether the books are kept on the basis of originally invested dollars or of current dollars, management must retain a share of earnings sufficient to meet replacement costs as and when incurred, unless it is prepared to resort to the money market for the necessary funds."

A careful reading of a leading article frequently quoted indicates that most of the business men questioned on the subject recognized the problem for what it is – a matter of business policy and finance. Only a majority would upset the usual methods of determining corporate income. A disturbing feature of the current situation is that the minority view makes the headlines and we are confronted with a barrage of inquiries to the effect that "if some of the biggest corporations in the country do it why can't we." Our answer has been that we have not approved any departure from presently generally accepted accounting procedures and have no intention of doing so until we are convinced that the minority has a better case than has been presented to date. This appears to be the position of the American Institute of Accountants which I trust will prevail.

No discussion of current accounting problems would be complete from our point of view which failed to touch upon the treatment of employees' pension and benefit plans.

In the great majority of cases these plans are voluntary on the part of the company and may be altered or discontinued entirely at the will of the management. As a practical matter even under these so-called voluntary plans in which there is no strict legal liability to continue pension payments it is doubtful that a corporate management expecting to remain in business and enjoy good labor relations would – if in fact it could – abandon a pension plan. A realistic approach is to give recognition in the accounts to the liability. However, in the absence of a clear-cut legal liability we have not, as a matter of policy, insisted upon the showing of an actuarially determined liability for the accruing pensions. Instead a clear footnote explanation is accepted.

If the plan provides for the purchase of annuity contracts from an insurance company or the establishment of a trust fund, in either case based on past service of eligible employees or former employees now on pension, we are faced with considerable diversity of opinion as to the proper accounting. The funding of pension costs based on past service may be accomplished by lump sum or installment payments to the trustee concurrent with payments covering accruals for the current year. Payments covering the current year are clearly profit and loss charges. However, payments based upon past service, whether they be for the benefit of former employees now on pension or employees currently on the payroll, are claimed by some to be proper charges to earned surplus on the grounds that such payments are for service rendered in prior years and have no relation to current income. A more realistic view is that, in either case, payment actually is being made for a current benefit in the form of better employee relations, reduced labor turnover and other benefits currently and in the future and hence the payments should be charged to profit and loss; and many companies who file statements with the Commission do charge both types of payments to profit and loss. However, we have felt that until such time as uniformity of practice is attained in the profession with respect to this problem insistence upon the charging of these payments to profit and loss is unwarranted. Under either procedure it is essential that the circumstances be fully explained.

The most serious problems arise in a few cases of company managed pension plans which admittedly create a legal liability. In such cases the liability should be determined on an actuarial basis and given recognition in the accounts. If the irrevocable element of the plan applies only to those qualified and placed upon the pension rolls the question then arises as to the approaching liability for active employees on the payroll. As I indicated earlier, we have felt that a realistic view of the problem would require at least a surplus reserve determined on an actuarial basis although in practice a footnote explanation is all we insist upon.

Recent experience with pension plans indicates that the independent accountant should review their terms with the greatest care and question management and counsel closely as to the precise nature of the obligations imposed on the company by the plan, for in some cases the actual liabilities have been substantially understated while in others inadvertent misrepresentation has crept into explanatory footnotes.

The problems I have discussed seem to apply in some degree to most of the statements which come to our attention. In addition there are numerous matters which plague us from time to time with more or less regularity in individual cases. To comment upon all of these items at length would, I am sure, overtax your patience. However, it appears desirable to enumerate a few of them if only to assure the younger generation of accountants that there is still work to be done and to dissuade the older generation from resting on their oars. A list of such items would include: officers' and employees' stock option and bonus plans, when and how should charges against income be measured; premiums on exchanges of preferred stock, under what circumstances should they be recorded; classification and disposition of development expenses of non-ferrous metal mines; mergers and consolidations versus acquisitions and the related problems of intangibles and earned surplus; quasi-reorganizations, under what circumstances, if any, should recognition be given to appreciation in value of assets; contingent assets and liabilities, to what extent should conditions arising after the balance sheet date be reflected in the financial statements; treatment of unrecovered losses and development expenses such as those peculiar to the airplane industry; recognition of income pursuant to oil lease and option arrangements; and treatment of properties sold and leased back to the seller.

In our efforts to solve these and other accounting problems which arise in our day to day work our objective is to insure that financial statements filed with the Commission shall not be false or misleading with respect to any material fact or omit to state any material fact necessary to make the statement not misleading. I am sure that the accounting profession has the same objective except that yours is a broader field in that it embraces all financial statements.