FOOTNOTES TO FINANCIAL STATEMENTS

Address

of

Earle C. King

Chief Accountant, Securities And Exchange Commission

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FOOTNOTES TO FINANCIAL STATEMENTS

Not since 1917 have I had the pleasure of being in Richmond. At that time, as a junior accountant industriously engaged in checking footings and postings, I could have or at least would have answered any accounting problem. That was 30 years ago. Now I hesitate to attempt to answer any accounting problem but I do have some opinions which I shall venture to express. You will understand, I know, that these opinions are strictly my own and are not to be considered those of the Commission.

The subject upon which I have been asked to talk is FOOTNOTES TO FINANCIAL STATEMENTS. I wonder if any of us have ever thought of the part that footnotes play in our daily activities. Your railroad timetable has numerous hieroglyphics referring to footnotes (usually in such fine print that they are scarcely readable) which state that this train runs only on week-days, or that one on Sundays and holidays; your insurance policy is very clear as to what you pay but for information as to what you are insured against you must read several paragraphs of footnotes which may indicate that after all if anything happens, it's your fault and you can't expect the insurance company to be responsible; your restaurant bill-of-fare is generally replete with asterisks which refer to footnotes informing you that the "complete" dinner includes everything except soup, vegetables, beverage and dessert. I recently saw one of these large size bills-of-fare in a restaurant window which included an item "Special fresh vegetable dinner with poached egg"; an asterisk before the item referred to a footnote which stated "No fresh vegetables." Footnotes are encountered at every turn; it seems that they are as unavoidable as taxes.

And rare, indeed, is the case of financial statements containing no footnotes. It is practically impossible to present an understandable and candid set of financial statements without some explanations which, as a practical matter, can not be shown on the face of the statements. And no basis exists for determining just what and how many notes should be shown other than the applicable circumstances. We have all seen statements which contain so many footnotes or such lengthy ones that they confuse rather than enlighten. We also find statements the usefulness of which is impaired by the scarcity or terseness of footnotes.

The necessity for footnotes is attributable as much to the wide variety of generally accepted accounting principles which exist in some fields as to the lack of generally accepted accounting principles in others.

At present Regulation S-X, which is the Commission's basic accounting regulation and which prescribes the form and content of most financial statements filed with the Commission, makes provision, with respect to commercial and industrial companies, for thirty or more footnotes. Not all of these footnotes are necessarily applicable to any one set of financial statements but might be were all the circumstances present. Obviously it would be highly desirable to dispense with many of these footnotes. But so long as optional accounting principles may be applied with respect to similar transactions or chameleonic captions may be used in financial statements, it seems essential that, in statements filed with the Commission, complete explanation be required with respect to such matters as depreciation, depletion and amortization policies; the basis of carrying plant and property, securities and other assets; the source, nature and use to be made of reserves; and many others.

The accounting profession has been striving for many years to establish a code of principles and practices which will result in financial statements that are meaningful, consistent with regard to the treatment of similar transactions, and which are not subject to misconstruction. Much has been accomplished in this direction, particularly during the last eight or ten years. As you know, the American Institute of Accountants has published twenty-nine Accounting Research Bulletins and twenty-two Statements on Auditing Procedure which, while they may not always be followed religiously by the entire profession, have made the profession alive to its problems, and the Commission has been, I think, of considerable assistance in this program.

Usually when an accounting principle or practice, which may have been for many years the subject of debate among accountants, becomes generally accepted by the profession, it is included or reflected in our forms or regulations. There are, of course, exceptions to this procedure, principally in situations where, because of the requirements of the various statutes administered by the Commission, it is considered impracticable or contrary to the best interest of investors to adopt the profession's viewpoint. Such cases, however, are extremely rare.

In this connection the Commission, in 1937, announced a program "for the publication, from time to time, of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions." Pursuant to this program there have been published sixty-three Accounting Series releases, some of which indicate the Commission's views on accounting matters but most of which constitute an expression of opinion by the Chief Accountant concerning accounting and auditing principles and practices. Many of these opinions expressed by the Chief Accountant have their counterpart in the Institute releases referred to previously. Certainly, to anyone familiar with both the Institute and the Commission releases it must be apparent that both organizations have the same ultimate goal in mind.

There still remain, however, many points upon which the profession is not in agreement and in respect of which optional treatment is found reflected in financial statements. Furthermore, new problems are arising almost daily and it is especially as to these unsettled and new matters that the necessity for or desirability of footnotes comes into play. It seems to me that in such cases only by means of concise but clearly stated explanatory footnotes can the import of the statements be conveyed to the reader.

Of special interest in any discussion of footnotes is the Commission's Accounting Series Release No. 4, issued April 25, 1938. This release expresses a basic administrative policy of the Commission as to financial statements. It deals with the large area where specific rules and regulations as to methods and procedures of accounting to be followed are neither practicable nor desirable and where chief reliance of the Commission for the protection of investors is found in accounting principles and practices which have been recognized as sound by professional accountants generally. The release reads as follows:

> "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the

Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."

The application of Release No. 4 to the subject of footnotes is well illustrated by Accounting Series Release No. 53. In that release the Commission dealt with a practice - - tolerated by some accountants and sincerely advocated by others - - pursuant to which the current income account was charged, under the heading of income taxes or charges in lieu of income taxes, not only with the actual amount of income taxes expected to be paid by the company but also with an additional sum equivalent to the reduction in taxes brought about by unusual circumstances in a particular year. This additional charge against income was, in most cases, offset either by a credit to surplus or by utilizing the reduction for some special purpose such as eliminating a portion of unamortized discount on bonds. The principal conclusions announced in the opinion were that:

1. The amount shown as provision for taxes should reflect only actual taxes believed to be payable under the applicable tax laws;
2. The use of the caption "charges or provisions in lieu of taxes" is not acceptable; and
3. 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.

In the many cases considered by the Commission which led to the adoption of the release there seldom was any question as to the adequacy of the factual or technical disclosure furnished in footnotes. It was the Commission's opinion that these disclosures, however extensive they might be, did not overcome the fundamental misrepresentation inherent in the resulting statement presentation. The Commission therefore reached the conclusion that amendments would be required pursuant to Release No. 4. In view of the conflicting opinion contained in the Institute's Bulletin No. 23, the Commission felt that it was advisable to formalize its views in Release No. 53 and therefore bring into application the second part of Release No. 4 which requires amendment where the accounting treatment is contrary to an express rule, regulation or Commission release.

You, of course, are familiar with and vitally interested in the various accounting problems, old and new, the solution of which is being sought by your profession. Some of you, I know, are actively engaged, either as individuals or on committees of your state society or the American Institute, in solving these problems. I should like, however, to review briefly these problems - - or at least some of the major ones - - as they arise in formal statements filed with the Commission, to indicate our viewpoint thereon and discuss the importance of footnotes in connection therewith.

Because of the complexity of the property accounts of public utility companies financial statements usually contain lengthy footnotes discussing the nature of the properties, their estimated useful lives, and the basis of providing for depreciation thereon. Until quite recently it was not uncommon to find a qualification in the accountants' certificate applicable to a public utility statement worded as follows:

> * * * Subject to the adequacy of the provision and the reserve for depreciation, as to which we are not in a position to express an opinion, the accompanying balance sheet * * * presents fairly * * *

Such a qualification, even when the company's depreciation methods were fully explained by footnote, left the reader of the financial statements in doubt as to whether the depreciation reserve shown on the balance sheet and the provisions for depreciation included in the income statement were adequate. It is now Commission policy that the accountants' certificate will be unacceptable if qualified in this respect. If the accountant has any doubts as to the adequacy of the depreciation provisions or reserve, or if he thinks them inadequate, he is required to so state in his certificate.

The adoption of this policy by the Commission had an immediate effect upon the content of footnotes pertaining to depreciation. For example, the accountants' certificate contained in a recently filed registration statement was qualified in the manner indicated previously. The qualification was removed from the certificate before the statement became effective but the footnote explaining the Company's depreciation practices was changed. The footnote contained in the financial statements as originally filed indicated that the retirement reserve method of accounting had been followed, that applicable systems of account prescribed by regulatory authorities provided for depreciation accounting, that studies were in process to develop a method of accounting conforming to the systems prescribed, and that,

> "In the opinion of the management, the property retirement reserve is adequate in amount to reflect the accrued depreciation in plant and property, determined on an age-life basis <u>in accordance with accepted methods of depreciation accounting</u>, although such reserve is not believed to reflect accrued depreciation computed in accordance with the so-called straight-line (or zero interest) method." [emphasis supplied]

As amended the phrase "determined on an age-life basis <u>in accordance with accepted methods of depreciation accounting</u>" [emphasis supplied] was changed to read "determined on an age-life basis <u>calculated pursuant to the six per cent present worth method of depreciation accounting</u>," and the following essential statement was added to the note:

> "The Company has received an opinion . . . [from its] independent consulting engineer . . ., which supports the opinion of the management expressed in the preceding sentence."

The independent accountants then added the following interior paragraph to their certificate:

> "As stated in Note __ . . . the general practice of the company is to make such appropriations to property retirement reserve from current income as are considered by the management to be necessary to provide for retirements when they occur, rather than on the basis of estimated useful lives of individual units of depreciable property. We have reviewed the studies of the properties made by the independent consulting engineer mentioned in the note. . .; the accumulated property retirement reserves. . . and the related provisions. . . are adequate to meet

the requirements of depreciation accounting under the six percent present-worth method, although not under the straight-line method. . ."

Footnotes are especially important in connection with a problem that has been of considerable concern to us in recent years; one which results in frequent citing of deficiencies in the form of requests for greater clarity in presentation of the facts, and occasionally in a change in balance sheet and profit and loss treatment. I have in mind the question of employees' pensions.

In the great majority of cases these pension 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 I think serious consideration should be given to the proposition that even under voluntary plans in which there is no strict legal liability to continue pension payments a corporate management expecting to remain in business and enjoy good labor relations would not – if in fact it could – abandon a pension plan, and a realistic approach is to recognize 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. 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 or which will prohibit direct charges and credits to earned surplus, 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 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, I think 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.

Another unsettled problem involving footnotes – a problem that has lain dormant for a number of years but which has come to life again as a result of inflated prices – involves the creation from income of reserves for future inventory price declines and losses. The result, if not the objective, of this procedure, in my opinion, is improperly to reduce current profits and increase profits of subsequent periods. It is our position that provisions made to reserves for inventory losses may be charged against income <u>only to the extent that the losses have actually taken place but have not been realized by use or sale of the materials involved</u>. And any reserve so provided, being a valuation reserve, should be deducted from the inventory on the balance sheet. If it is considered necessary or desirable to provide a reserve for losses which it is expected will occur in the future, such provision, in my opinion, is no more than an appropriation of net income or earned surplus and should be so treated.

In a number of instances statements have been filed reflecting the use of novel inventory methods and involving a reserve for future losses. In one or two cases a major fault of the procedure was simply the failure to explain in the footnote that the purpose and effect of the reserve was to place the inventory on a LIFO basis. In the other cases most of the reserves were, in our judgment, surplus appropriations. As to these we have required that there be given a clear footnote explanation of this fact together, of course, with corresponding statement treatment and a representation that the reserve ultimately will be returned to surplus.

In one fairly typical case the company explained its inventory reserve as representing the amount by which the valuation of inventory quantities on hand at the beginning of the year was increased as a result of applying the customary methods of pricing inventories (which was FIFO) at the end of the year, after giving consideration to the income tax effect. It stated that its intention was to charge the reserve with inventory losses (net of tax effect) that might result from possible future price declines. The provision had been included in cost of sales but the reserve was carried on the right-hand side of the balance sheet. As amended, the reserve was shown as a deduction from the inventories and the footnote was changed to state that the procedure had approximately the same effect as if LIFO had been used.

The question of inventory reserves against future price declines illustrates the inability of footnotes to deal with such inherent deficiencies as the lack of objective criteria and inconsistency of internal statement treatment as between the income provision and the reserve on the balance sheet, the principal difficulties we encounter with most reserves of this kind. In the early cases which we dealt with it was found that no amount of explanation that could or would be given as to the character and operation of the reserve satisfied the requirements of methods such as LIFO, FIFO, average cost, etc., having the characteristic of being systematic, objective and not subject to tinkering because of alleged special circumstances.

Another old problem now found in a new setting concerns the establishment and use of reserves for war, post-war, and general contingencies. Although similar reserves have appeared occasionally in past years, the reserves that came into existence as a result of the war have caused us the most trouble. In view of the very great diversity of accounting treatment in actual practice and the widely varying opinions held, the solution we turned to initially was based on disclosure, meaning largely footnote explanation. Briefly stated, our practice, as outlined in Accounting Series Releases Nos. 42 and 54, has been to require with respect to reserves a full disclosure of their source, nature and disposition and to the greatest extent possible a demonstration that the cost or expense under consideration is directly or fairly allocable to the income of the year in which the provision is established by charges to profit and loss. Recent practice has been to require a positive statement in a footnote relating to the reserve that the account will not be used in such a manner as to relieve the income account for any future period of a charge that should properly be made in that period and that any unused portion of the reserve will be credited to earned surplus when no longer required for the purpose for which created. In my opinion charges creating reserves for unforeseen contingencies of future periods have no place in the determination of net income. If such reserves are established – and it is by no means a settled question that they should be – the appropriation should be made from earned surplus.

Our allergy to the creation of reserves such as the foregoing should not, however, be construed as applying to necessary reserves. We had an interesting case not so long ago which further illustrates the importance of footnotes, how they are such a part of the financial statements and the accounting involved that it must now be obvious to anyone how futile it is to try to think of the statements and notes as something distinct and separable. The case also illustrates the Commission's concern with inadequate footnote disclosure and the extent of correction that may be required.

In this case the company, a public utility, carried an investment in certain property on its books at a figure of approximately $47,000,000. The utility, which was under order to dispose of the investment, proposed to sell securities and for this purpose filed a registration statement with the Commission. The company had a general reserve of approximately $8,000,000 which it intended to be used to absorb the loss on disposition. However, the identification of this reserve with the anticipated loss in the investment was not made in the statements or footnotes. Moreover, the applicable footnote, while acknowledging the possibility of a loss of indefinite amount, failed to state that the company itself admitted a probable loss of something like $17,000,000. Our study of the question indicated an even greater loss. Subsequently the company amended the footnotes to call attention to the existing reserve but did not change the explanation which stated that the amount to be realized from the property could not be determined in advance of actual sale and that in the opinion of the officers of the company the amount at which the investment was carried, less the reserve, was substantially in excess of probable current realizable amounts. We considered the statements deficient because of the failure either to disclose the extent of the probable losses or to provide adequate reserves. Since adequate reserves would have been a necessity in the face of full disclosure and since proper provision in the accounts would have created a deficit for the company, the company requested and was granted permission to withdraw its registration statement.

Another recent registration statement filed with the Commission highlighted the importance of an early solution to the perplexing problem of the income and surplus account. Should the profession fail to reach an acceptable solution for the uniform treatment of extraordinary charges and credits to income or surplus, investor confidence in the reliability of certified financial statements may be undermined. In the case I have in mind the consolidated profit and loss statement filed 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 labeled “Net Profit” or “Net Income” or “Income for the Year.” The final figure was described as “Balance to Earned Surplus.” 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 responsibility of the management to determine a net income figure and 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. 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.

Accounting for fixed assets is the subject of footnote treatment in all financial statements filed with the Commission in which the items are present. As you are aware, Regulation S-X requires as a footnote to the profit and loss statement a statement of the policy followed during the period with respect to the provision for depreciation, depletion and obsolescence of physical properties, the accounting treatment for maintenance, repairs, renewals and betterment and the adjustment of accumulated reserves at the time properties are retired or otherwise disposed of. During the war and immediately following its close the treatment of emergency war facilities also was the subject of necessary footnote explanation.

Interest in the accounting for fixed assets, a the case of inventories, follows closely the trend in the business cycle. The 1920's were a period in which the upward appraisal of fixed assets was popular and the importance of higher replacement costs and presence of values in excess of the book figures was stressed in financial, legal and regulatory circles. The 1930's saw a reversal of this situation and extensive writedowns of properties were the vogue, sometimes to the extreme of reduction to nominal amounts and the practical elimination of depreciation charges. Footnote explanations of the situation were a necessity if proper comparison of results for a series of years was to be made.

A little over a year ago the Commission considered a registration statement of a manufacturing company in which the footnotes revealed that fixed assets were carried at appraisal values. The independent accountants' certificate was in standard form and unqualified. Inquiry developed that the company followed the policy of recording reappraisals of its physical properties from time to time "to the end that the book value of the corporation's assets and of its stock might approximate as nearly as possible to current replacement values." We took the position that this procedure was contrary to sound and generally accepted accounting principles and required a revision of the financial statements to a cost basis despite the contention by the certifying accountants that the use of appraisal values for the purposes of reporting fixed asset values is sufficiently widespread to constitute the use of accepted accounting principles and practices. Accounting Research Bulletin No. 5 published in April 1940 was cited in support of our position. That bulletin, as you may recall, states that "Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient. Appreciation normally should not be reflected on the books of account of corporations." No dissents to this bulletin by any members of the Accounting Procedure committee were noted. The cost basis for tangible fixed assets was reaffirmed in Bulletin No. 24 published in December 1944.

The term depreciation as used in accounting has been considered by the profession for many years and has been the subject of reports by the Committee on Terminology of the American Institute of Accountants. Two of these reports have been published in the Accounting Research Bulletin series, Nos. 16 and 20. The latter in November 1943 defined depreciation accounting as "a system of accounting which aims to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation." I had believed that this concept and that of the cost basis for recording tangible fixed assets had attained practically complete acceptance in accounting circles in this country. However, the high price levels since the close of the war have resulted in some evidence of a resurrection in business circles of the attitude of mind which prevailed in the 1920's with respect to plant and equipment values and the accounting therefore. Recent public discussion in financial journals has revived the theory that depreciation accounting is directly related to replacement of fixed assets and that currently reported profits in most cases are overstated by the failure to recognize this alleged fact. Application of this idea in financial statements in a diversity of forms has come to my attention recently.

The Crane Co. in its annual report for 1946 discloses an item of $500,000 under reserves in its balance sheet labeled "Appropriation toward excess of future replacement cost of machinery and equipment over original cost." The profit and loss statement shows a caption "Net profit for the year" from which the $500,000 appropriation is deducted and the final caption is described as "Amount of profit transferred to earned surplus." The complete footnote explanation is "Pursuant to action by the Board of Directors, the Company made an initial appropriation of $500,000 out of 1946 earnings toward the excess of anticipated replacement cost over original cost of its older and less efficient machinery and equipment. This does not represent the total of such additional cost that would be experienced if the Company were faced with immediately replacing all of its machinery and equipment and does not take into account such possible costs in regard to land and buildings."

While I can see no objection to this treatment of what is, in effect, a surplus reserve, I fear that the last figure on the profit and loss statement rather than the "Net profit for the year" before the deduction of the appropriation will be considered the net profit. An appropriation debit in the earned surplus account instead of in the profit and loss account would avoid the possibility of confusion.

A second approach to the problem of the effect of the high level of prices on fixed asset costs is found in a proposal which we were asked to consider to segregate by some formula the excess costs incurred in new construction and to amortize the sum so determined over an estimated limited period of excess earnings – the basic element to be subject to normal depreciation. This procedure carries over the principle of the treatment of war time emergency facilities to peace time operations. The idea seems to be subject to certain defects in conforming to the concept of allocation of cost over estimated useful life in a systematic and rational manner in that the period of excess earnings and extent of the excess cost appear to be difficult to determine.

A third treatment of the problem is that reflected in the United States Steel Corporation Quarterly Earnings Report to its stockholders for the quarter ended June 30, 1947. This report shows under the caption "Wear and exhaustion of facilities" two items – an amount based on original cost followed by an amount "Added to cover current cost," \$6,700,000 in the second quarter, \$12,500,000 for the half year. No indication was given in the first quarter's report that this innovation in accounting procedure had been adopted. The explanation in the second quarter's report warrants quotation in full:

> "The reported income for the second quarter of 1947 reflects an increase of \$6,700,000 in the amount deducted as a cost covering wear and exhaustion of facilities over that based upon the original cost of such facilities. The present-day cost of new facilities to replace those worn out through use in production is substantially more than the original cost of the facilities so replaced. If the charge for wear and exhaustion of facilities installed in earlier years is continued on the old basis of their original cost, the resultant reserve will be inadequate to cover the cost of the replacements which will be necessary when these earlier facilities have served their useful life.

> "In the first quarter of 1947 the problem was dealt with tentatively by including a provision for a part of the cost of current construction in the charge for goods and services purchased.
>
> "In the present statement the amount so charged and a corresponding amount for the second quarter are shown as additions to the charge for wear and exhaustion of facilities as ordinarily computed in the past. The principle involved is analogous to that applied by U. S. Steel sine 1941 in the use of the 'last-in, first-out' method of determining the cost of products and services sold in respect of inventories. However, the added amount for wear and exhaustion is not presently deductible for income tax purposes.
>
> "The additional charges are equivalent to thirty per cent of the charges for depreciation as ordinarily computed in the past. This is materially less than the percentage of increase in cost of new plant construction over pre-war cost but it is deemed appropriate at the moment pending further study."

Note particularly that this explanation indicates that the charge of $5,800,000 to cover depreciation on excess replacement cost of facilities was included in the item "Products and services bought."

This procedure is clearly contrary to any concept of depreciation accounting which would distribute the <u>cost</u> of the assets over their estimated useful lives in a systematic and rational manner, and results in a direct understatement of profit as determined on the cost basis.

A fourth and last variant on the treatment of high construction costs that has come to my attention is the case of DuPont. This company's Semi-annual Statement, as of

June 30, 1947, to its stockholders includes under "Reserves" in the balance sheet an item "Excessive Construction Costs - $10,500,000," and a charge in the statement of Consolidated Income of a similar amount, of which $5,300,000 was for the first quarter. The charge is shown as a deduction immediately following the caption "Net Operating and Other Income" before arriving at "Net Income for the Period" and is captioned "Provision for Excessive Construction Costs." The amounts involved are approximately one-sixth of the resulting net income for each quarter. The note relating to the items reads as follows:

> "Current construction costs are believed to be excessive. Therefore, effective January 1, 1947, the Company elected to anticipate accelerated depreciation in the early years of operation of newly constructed plants by setting aside out of Net Operating and Other Income a reserve for excessive construction costs in the year incurred. It is the present intention that, when the plants come into operation, depreciation will be provided at normal rates on the gross amount of plant cost."

As I read the quoted footnotes applicable to the DuPont and Steel statements it appears that these companies have determined that extraordinary depreciation charges are necessary for the current year on opposite grounds – one on the theory that current costs of construction are temporarily excessive and should be absorbed immediately; the other on the theory that present prices are here to stay, or at least for some time to come, and that replacement of current facilities will be at higher price levels which should be provided for now. I can find no basis for reconciling the procedure followed by either Steel or DuPont in their current quarterly reports to stockholders with any generally accepted treatment of depreciation or with the principle of matching costs with revenues. And, in my opinion, abandonment of the cost basis of accounting in favor of any of the plans so far revealed in current reports is unjustified unless and until reconsideration of every aspect of the problem (for the problem is not new) indicates the propriety of such course.