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CURRENT ACCOUNTING PROBLEMS

Address of

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Accountants, it seems, always have "current problems." Some of us would not have much to do, but our lives would be much less interesting, if that were not the case. If all concerned had a better gift of prophecy, or perhaps if all could be convinced that economic or business disturbances, both inflationary and deflationary, are recurring, and consequently some accounting problems are also recurring, we might make more headway in reaching mutually acceptable solutions.

From its inception the Securities and Exchange Commission has had the active cooperation of accounting teachers and practitioners, both public and private, in the development of its accounting rules and regulations. Reciprocally, the Commission has had an active interest in the work of the American Accounting Association in the preparation of its successive statements of "Accounting Principles Underlying Corporate Financial Statements" and in the work of the American Institute of Accountants' Committees on Accounting and Auditing Procedure.

All of you, of course, are familiar with your own Association's statement, the bulletins of the Institute's committees, and with the accounting requirements of the S. E. C. as reflected in Regulation S-X, Accounting Series Releases, and in published opinions. While I realize that registrants with the S. E. C. represent only a small fragment, in numbers, of business units in the United States, I think we can assume that sooner or later accounting students training to enter the profession of public accounting may serve such registrants. When they do, in serving commercial and industrial clients, they will deal with an agency interested in obtaining a reasonable degree of consistency in the form and content of financial statements of companies not required to comply with a uniform system of accounts, as in regulated enterprises. Although the first registration and report forms adopted by the Commission included rather specific instructions as to the content and, more especially, the form of the financial statements to be filed, the instructions now found in Regulation S-X permit a certain amount of variation in terminology, form and content. After some disturbing experiences and difference of opinion on the basic question, the Commission in 1938 issued a statement of its administrative policy with respect to financial statements:

> "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."

This statement of policy is a declaration by the Commission consistent with recommendations made by Professor Paton at an Illinois accounting conference in 1946 that, "First, management must become more receptive to the view that accounting is not designed to paint pictures corresponding to managerial whims and prejudices. In other words, management must become more willing to let the accountants call a spade a spade – show things as they are rather than as management would like to see them. Second, accountants must become more resourceful, adaptable, less hidebound, so that management may be effectively assisted. Third, both management and accountants should remember that their primary responsibility is still to the investors – those who put up the money – the folks who have been the forgotten men for some time." I certainly have no quarrel with those sentiments. They remind me of a particularly difficult conference in which counsel for the registrant did most of the talking in support of a treatment of reserves to which we had taken exception. After the conference broke up one of the group was overheard to remark that "they seem to want us to tell the truth rather than be conservative."

Most of our "current problems" arise in the appraising of transactions reflecting new methods of doing business or matters upon which there has been a wide difference of opinion among recognized accounting authorities for many years. Thorough analysis and discussion of the new problems and reappraisal of the old controversial problems are matters of mutual interest for all of us here, as well as for the registrants and certifying accountants directly concerned. Two articles which appeared in <u>The Accounting Review</u> a year ago suggest the possibility of discussing some of these problems under the general theme of consistency in accounting.

One of the articles expresses the fear that the doctrine of consistency is being followed blindly by accountants and therefore improvement in accounting practices is being prevented. This view is somewhat in contrast with the other article dealing with examination of 150 current (1946-1947 vs. 1945-1946) reports to stockholders. This article contained the statement that "none of the opinions [of independent public accountants] included exceptions, qualifications, or explanations bearing <u>directly</u> upon the question of consistency with respect to generally accepted accounting principles." The author listed ten classes of items gleaned from the reports which <u>seemed</u> to him to be cases of inconsistency.

Dealing with this problem is a major part of our work in reviewing the financial statements filed with us and I think I can assure you that our efforts are not directed to suppressing disclosures of inconsistencies from year to year. On the contrary, we insist upon exceptions being noted if the changes are significant. And there is where the element of judgment enters. There are usually four parties involved in a conference over such matters if a registration under the 1933 Act is involved – representatives of the registrant (usually the chief accounting officer), a partner of the firm of certifying public accountants, a representative of the underwriters, and accountants of the Commission's staff. If the conference is a pre-filing one, it may have been suggested by any one of the parties; if after filing, it probably resulted from a letter of deficiencies. Such a conference is an informal means of getting at the facts behind the accounting and usually leads to a conclusion as to whether an exception as to consistency or a change in method of accounting or reporting is necessary.

The rules that govern whether an exception should be taken as to consistency are found in Regulation S-X. Among other requirements rule 2-02 says that “The accountant’s certificate shall state clearly: * * * the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3-07; * * *.” Rule 3-07 requires that “If any significant change in accounting principle or practice, or any significant retroactive adjustment of the accounts of prior years, has been made at the beginning of or during any period covered by the profit and loss statements filed, a statement thereof shall be given in a note to the appropriate statement, and, if the change or adjustment substantially affects proper comparison with the preceding fiscal period, the necessary explanation.” To complete the disclosure, rule 2-02 goes on to require with respect to exceptions that, “any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.”

Experience seems to indicate that most registrants and their independent public accountants prefer to have the financial statements and accountants’ opinion contained in the report to stockholders in substantial agreement with the report to be filed with the S. E. C. Since the report to stockholders usually is published weeks or months before their report is filed with us, our requirements must be anticipated, or, if a troublesome point is known to be present, conferences are sometimes requested prior to publication of the report to stockholders. Occasionally when agreement has not been reached before such publication the report to us may be different from the report to stockholders and attention may be called to that fact.

There is no real difference in our requirements for disclosure of inconsistencies in accounting from those which prevailed in the accounting profession prior to the existence of the S. E. C. In the three-way correspondence relating to audits of corporate accounts between the American Institute of Accountants, the Controllers Institute of America and the New York Stock Exchange in December 1933 and January 1934, agreement was reached as to a short form of accountants’ report in which the opinion paragraph contained the phrase “in accordance with accepted principles of accounting consistently maintained by the Company during the year under review." One of the notes referring to this report contained the warning that "This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated." The form of report and the accompanying instructions as to its use were included in 1936 in the American Institute of Accountants' bulletin entitled "Examination of Financial Statements by Independent Public Accountants" which was in use unamended until the series of Statements on Auditing Procedure was launched in October 1939 following the disclosures in the McKesson case. The first of these statements recommended a short form report or opinion which closed with language still in general use – "in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

It may be noted that rule 3-07 speaks of "any significant change in accounting principles or practice" whereas the note to the Institute's 1934 certificate refers to "any material change either in accounting principles or in the manner of their application." Occasionally an accountant has maintained that in a particular case there was no change in accounting principles – the difference in the figures as between years being due only to the manner of applying the principles. A revision of Regulation S-X now in process will eliminate this opportunity to quibble by amending our rule to include change in manner of application as well as change in principle.

Sometimes attention is directed in the statements themselves to a change in the method of their preparation. When two years' figures are presented and the earlier year is adjusted to conform to the later year the statements are comparable and of course no exception as to consistency is necessary. A good example of this situation recently came to my attention. (My reference here, as well as the other examples I shall use unless clearly indicated otherwise, is to the published report to stockholders.) In 1947 a substantial profit on the sale of land and buildings had been shown as a non-recurring credit to net income. In the 1948 report, presented in comparative form, this item was shown in earned surplus for 1947 where the change in procedure was noted, and in the 1948 earned surplus there was a substantial debit for development costs abandoned. Handling the 1948 extraordinary debit as the extraordinary credit had been reported in 1947 would have resulted in net income being reported as approximately one seventh of the preceding year whereas by the change in procedure the net income for 1948 was shown as one eighth more than 1947. The latest revision of one of the leading accounting texts in discussing extraordinary debits and credits to income or surplus endorses the method adopted here for 1948 although the author recognizes that advocates of a “clean surplus” would show these items in the income account. The example I have cited seems to me to be a clear cut case of handling the extraordinary items in the two successive years to attain the result desired. The amount of the debit was clearly large enough to come within the exception in the American Institute of Accountants’ Research Bulletins Nos. 32 and 35 but to which the Commission has objected on the grounds that such exclusion of profit and loss items from the income account is misleading. The outline for an income account set forth in Regulation S-X includes items of “Other Income” and “Income Deductions” requiring separate disclosure of significant amounts with explanations designating clearly the nature of the transactions involved.

This matter of a “clean surplus” compels me to observe that the teaching that adjustments of prior years’ profit and loss items must be made through earned surplus is reflected in many financial statements. Perhaps the most persistent single item given this treatment is adjustments of prior years’ income taxes. Supporters of either the American Accounting Association’s statement of accounting concepts or the Institute’s Research Bulletin No. 23 on “Accounting for Income Taxes” would report such adjustments in the income statement for the year in which the transaction took place, except that Institute members might follow the suggestion contained in their bulletin that if the corrections were so large as to be likely to produce distorted interpretations of income the entries might be charged or credited to surplus with an indication of the period to which they relate. A statement I saw a few days ago contained two tax adjustment credits to earned surplus and one debit for an additional assessment, none of the gross amounts being significant by any test and the net result being $19.00 one way or the other. Cluttering up earned surplus with such small items seems absurd even though the entries as made do have strict theoretical support in some quarters.

Accounting for the cost of vacation allowances has been the subject of comment in the 1947 and 1948 financial statements of several large corporations, with a variety of treatment. In one case, in which the company apparently disapproves of footnotes, for there are none, a short lucid paragraph in the accountants' opinion reports the change in accounting and takes a clear cut exception as to consistency in the following language:

> "Prior to 1947 it was the policy of the company and its subsidiaries to charge vacation payments to income account as and when the amounts were disbursed. Effective January 1, 1947 the companies adopted the policy of accruing the estimated cost of vacation payments in the year the vacation pay is considered to be earned, which change we approve. The profit for the year 1947 has, therefore, been charged with the cost of vacations paid as well as vacations earned in the year with the result the profit has been reduced by $1,630,000. In all other respects the principles of accounting maintained by the companies during the year were consistent with those of the preceding year."

The amount of the duplicate charge to income here was two per cent of wages and salaries, and approximately five per cent of net income and current liabilities.

In another company in the same industry served by the same firm of independent public accountants a similar change in policy was explained in a footnote with the accountants' exception as to consistency expressed in their certificate as follows: ". . . in conformity with generally accepted accounting principles applied on a basis consistent in all material respects with that of the preceding year, except for the change in accounting for vacation allowances explained on page 13, which change has our approval." In this case the duplicate wages were charged to surplus among other extraordinary debits and credits. The amount in this case was three per cent of wages and salaries, seventeen per cent of net income and seven per cent of current liabilities. In still another company in the same industry, served by the same accountants, the change in accounting for vacation pay is referred to in a footnote which in turn refers to an explanation in the text of the report. No exception as to consistency as to this point was taken by the accountants in their certificate although another change in accounting was mentioned. In this case the duplicate charge was to income and amounted to two per cent of wages and salaries, fifteen per cent of net income and four per cent of current liabilities. In statements filed with us the administrative problem of reconciling these varied treatments of the same situation becomes one of judgment as to significance of the accounting in each case, which is the same problem as faced the accountants. But we don't always agree!

As was to be expected, the published report of a correspondence school affords an example of an exception to consistency in the application of generally accepted accounting principles. The accountants in this case expressed their exception by the insertion of a phrase in the standard certificate to read: "which, except for the change (which we consider proper) in the treatment of recoveries and the provision for losses, as explained in Note A . . ." Note A explained that in the current year recoveries and provisions for losses were recorded in a manner which had the effect of increasing sales and provisions by approximately the same material amount but with no effect on gross or net income. The change in income tax regulations late in 1947 relating to deductions for bad debts by banks should be cause for a somewhat similar comment in bank reports where the change has been adopted, as I have seen in one well publicized bank report, which, however, contained no accountants' certificate.

Exceptions taken because of changes in accounting policy are not always related to transactions affecting profits. Two cases appeared in my small sampling in which the accountants noted changes (approved by them) in the manner of making provisions from surplus in connection with preferred stock retirements. The changes related only to the timing of the charges to surplus. Different accounting firms were involved.

A paragraph from the accountants' report to the board of directors and stockholders of a department store company will serve to introduce a subject which has had the attention of the Commission for a number of years but which has achieved considerable prominence in the last two years or so. The paragraph reads:

> "The accounting principles followed by the companies during the year have been consistent with those of the preceding year, except that payments under the employees' retirement plans applicable to services of prior years have been charged to earnings, whereas in the prior year such payments were charged to accumulated earnings retained in the business; this change, which has our approval, is explained in Note G to the financial statements."

Note G spells out the effect of the change and adds a paragraph:

> "It is estimated that the aggregate amount which may ultimately be paid in future years in respect of such services for prior years, if the plans continue, will approximate $4,850,000."

The policy to charge earnings for pensions based upon past services is in accord with the policy advocated by the Commission for some time and recommended by the Committee on Accounting Procedure of the American Institute of Accountants in Research Bulletin No. 36. The reasons for reaching this conclusion are adequately stated in the bulletin. However, an unsolved problem not even mentioned in the bulletin is suggested by the $4,850,000 in the note just quoted. Since a realistic approach to the problem leads to the conclusion that the liability must eventually be met, barring serious economic reverses, we feel that the liability actuarially determined should be reflected in the balance sheet. In the absence of a strict legal liability for the pensions based on past service, our practice has been to require a footnote represent as to the company's obligation under its pension plan.

Inventories are a recurring cause of trouble for accountants and for us, and should demand close scrutiny by the investor. Exceptions taken by certifying accountants on grounds of lack of consistency in the accounting principles applied in valuation are common. The accountants' certificate attached to the statement of an oil company refers to two footnotes dealing with changes in accounting principles. The first of these, dealing with changes in inventory valuation, sounds a bit complicated for a layman but should be interesting to a cost accountant:

> "Prior to 1948, additions to inventories from current production of natural gasoline products were valued at prices based on market, and additions to inventories of refined products at manufacturing cost computed on the by-product method, with crude oil charged at market value. For the year

> 1948, with minor exceptions, additions to inventories of natural gasoline and refined products were priced as manufacturing cost computed on the relative value method, refined product costs including crude oil at cost. This change in accounting procedure has resulted in reducing net income for the year 1948 by $5,245,017."

The other note dealt with a change in accounting for dry holes and concessions with a similar effect on income for 1948. A third note refers to the company's policy of making minor revisions in accounting procedures to conform to changing conditions and experiences, the effect of which, except for the two dealt with specifically, was not deemed significant.

Some of the airplane companies have had inventory problems since the war. For example, one such company noted a change to exclude commercial selling expenses from inventories (giving the amount in work-in-process at the beginning of the year). The abandoned procedure was a wartime practice appropriate under government contracts. The certifying accountants called attention in their certificate to the change.

In a certificate addressed to the stockholders of an old company in financial difficulties, the public accountants omitted a statement as to consistency with the preceding year but called particular attention in their certificate to the notes applicable to the financial statements. While somewhat long, I think the four paragraphs are of sufficient interest to quote:

> "Members of our staff were present at the plant of the Company when the inventories were being checked physically and observed the work of the Company's employees in that connection. We reviewed the methods used in taking and compiling the inventories and made physical tests sufficient to satisfy ourselves as to the substantial accuracy of the inventory quantities. We also reviewed the pricing of the inventories and ascertained that they were stated on the basis of materials and direct labor, as customarily computed by the Company for inventory purposes, with provision for slow-moving, obsolete and irregular items. Pursuant to the Company's consistent practice, all indirect manufacturing costs were omitted from the inventory stated on the balance sheet.
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> "If effect were given in pricing the inventory to t he Company's current costs as to materials and direct labor and to an application of estimated indirect manufacturing costs, the inventory at the close of the period valued on the basis of lower of cost or market, would have been increased approximately $1,580,000. It is estimated further that if the opening inventory had been valued on a similar basis, the operating loss for the year 1947 would not have been materially changed.

> "During the year ended December 27, 1947, the Company made no provision in its financial statements for the customary contribution under its pension plan for past services. The Company also changed its basis of providing for current costs of the pension plan from the previous practice of making annual provision therefore and now meets current costs of the pension plan on a monthly basis. It is estimated that the loss for the year ended December 27, 1947 would have been approximately $170,000 greater if the Company had continued to make provision for pension plan payments on the former basis.
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> "In our opinion, the accompanying balance sheet and the related condensed statements of profit and loss and surplus, together with notes to financial statements, and comments contained in this certificate, present fairly the position of [the] * * * Company at December 27, 1947 and results of operations for the year then ended."

In contrast to the above case, in the examination of the financial statements of a new registrant under the Securities Act it was observed with respect to inventories that "costs as to work in process and manufactured stock include material and labor only, without manufacturing or other overhead." Despite this comment in the note the certifying accountant expressed the opinion that the statements "with their footnotes" were in conformity with generally accepted accounting principles and practices applied on a consistent basis. The footnote dealing with inventories as it became effective was amended to show what the inventories at the several year ends would have been if manufacturing overhead had been included. The effect on income was also set forth. The accountant's certificate was amended to include a paragraph taking exception to the inventory methods of the company, in the following language:

> "Under the Company's practice, work in process includes material and labor only, without manufacturing or other overhead. I am of the opinion that the inventory valuation of work in process more properly should include the applicable proportion of manufacturing overhead, but the effect of such inclusion upon the Company's assets and net income would be relatively insignificant, as shown in footnote D in the accompanying financial statements."

However, the first annual report filed with the Commission reflected a change in the accounting to include manufacturing overhead in the inventory and the accountant expressed an appropriate exception as to consistency in his certificate. On this point Montgomery's Auditing, seventh edition, has this to say:

> "Overhead Methods. - - In practice there is great latitude in the application of overhead to inventories. On the one hand, it is generally accepted that all overhead should not be charged off as incurred (Accounting Research Bulletin No. 29), and on the other, it is very rare that all items of overhead are appropriate to apply to inventories. As a corollary to the principle that all overhead should not be charged off, there is, I the authors' opinion, a presumption against the exclusion of reasonably determined overhead costs from inventory. The exclusion of such costs may sometimes be tantamount to a reserve which reduces the inventory below an accepted basis; such reserves are discussed in Accounting Research Bulletin No. 31, issued in October, 1947. There has recently been further support of the method of charging off fixed overhead as incurred and of applying to inventories only such items as vary with production; while this method is not widely in use and is not generally recommended, it may have merit under certain circumstances."

There are indications that this subject warrants further study.

The popular inventory method of "Lifo" has been praised and condemned so generously in poetry and prose by such masters of the English language as Peloubet and Wilcox that I hesitate to say anything on that subject. However, the topic is too important to pass over. Even opponents of the method must concede that "Lifo" is a generally accepted method for valuing inventories. The question before us then is whether the method presents any special problems of disclosure in financial statements intended to inform investors. Certainly a change from some other method of valuation to the "Lifo" method is a significant change in principle and usually results in sufficiently material effect on balance sheet and income figures to warrant full disclosure and an exception by the certifying accountant on the matter of consistency with prior years. For some elaborate disclosures of this type it is only necessary to turn to the department store field in which some companies had adopted the method in 1941, then abandoned the practice in the face of adverse Treasury Department rulings and then readopted the method after the favorable U. S. Tax Court decision in 1947. Some of the notes reciting these changes have required a full page in reports to stockholders. In situations such as these, where the differences in valuation between "Lifo" and a basis reflecting more nearly "current values" are material, we have required the disclosure in financial statements filed with the Commission that such differences exist. IT seems desirable, also, that where the "Lifo" method is used and no "cushion" exists, that fact should also be disclosed to avoid the possible interpretation by the investor that "Lifo" always indicates a safety factor.

A statement with respect to depreciation policy is a requirement of Regulation S-X and, as any reader of accounting literature knows, depreciation accounting is a popular subject for discussion. Certainly, the topic has not been ignored in the last few years in corporation reports to stockholders. Just what constitutes a significant change in depreciation policy has been the cause of some disagreement among accountants. Some have maintained that a mere change in rate is not a change in the policy to amortize the cost of the asset over its useful life and that such a change is a normal part of applying the policy as it is customary to alter the rate as more accurate estimates of remaining useful life becomes possible. Others insist that if the change results in significantly different depreciation charges, notice should be taken in the accountants' certificate so that the statements may not be misleading. This view was expressed by the first chief accountant of the Commission in an address in 1937. As indicated earlier in this paper, a literal reading of rule 3-07 does not seem to require this strict interpretation. A reexamination of the matter with leaders of the accounting profession led to the conclusion that the rule should be clarified on this point to include change in manner of application as well as change in policy. In the application of this rule it should be understood to apply to changes effected by management decision and not to changes in amounts of items due to outside factors beyond the control of management. A change in amount of depreciation, for example, due to a change in operating rate of a plant when depreciation is measured by rate of production would not require any comment as to consistency in the application of accounting principles. However, a change from a straight line basis to a productivity basis would require an exception as to consistency, as in this note to which the certifying accountant called attention, with approval, in his certificate:

> "It is the policy of the company to depreciate fixed assets over their estimated useful lives. Effective January 1, 1948, however, instead of the straight-line method heretofore used, it has been decided to allocate depreciation over future years based upon activity of each year as related to 'normal' activity. For this purpose the average activity for the 20 years ended December 31, 1943 has been chosen as representing 'normal'.

> The depreciation charged for the year ended December 31, 1948 is $95,721 in excess of what the charge would have been if the previous policy had been continued."

A year ago depreciation based upon purchasing power recovery or to provide for excessive construction costs, depending upon the circumstances in particular cases and the interpretation of their current economic condition by management, was the subject of active discussion in accounting and business circles. Today, to a large extent, accelerated depreciation has gained the center of the stage. For those who are interested in the immediate past history of this subject the 1948 annual reports to stockholders of United States Steel Corporation and E. I. du Pont de Nemours & Company furnish the most accurate statements available of the views of those exponents of these methods. Further discussion seems unnecessary here except to suggest that there is much to be said for substituting a method of depreciation based upon plant activity for straight line depreciation. I think we should start with the assumption that a decision to build a plant, a new store or an addition is based on the best business judgment of the management at the time as to the prospects for profitable employment of the property. It seems reasonable to me to assume also that demand in the immediate few years is easier to predict than that of the later years of a plant's potential physical life. The basis for accelerated amortization of the cost of plants during periods of anticipated peak demand seems to me to be well founded and much more realistic than the uniform application of a straight line rate of depreciation over a plant's anticipated useful life. Also obsolescence as a factor is recognized in any theoretical discussion of depreciation and should be taken into account in the early period of a plant's life for substantially the same reasons and also in anticipation of some possible new competing gadget. While recording plant assets at cost remains the generally accepted basis of accounting, the adequate recognition of activity and obsolescence factors should serve to produce a proper matching of costs with revenues.

In conclusion I want to revert to one of the articles I mentioned in the beginning. The author said that "the inclusion of words of exception, qualification, and even explanation in the accountant's opinion tends to carry or imply some stigma of wrongdoing or deviation from the authority. How to attain adequate disclosure in the face of this reaction is a real question." I confess that in our work at the Commission we see something of the background for the view here expressed. But I think I have shown by many examples that such a feeling is not universal and should not apply at all to an exception as to consistency when the change reported reflects an improvement in accounting policy. The examples I have quoted serve to illustrate how many accounting firms solve the problem very simply by stating the change and its effect on income, or other accounts affected, in their certificate or by referring to a footnote or, in some cases, to a page in management's report, in either case followed by the simple statement that they approve of the change. If the accountants' certificate carries any weight at all, and I assume it does, this treatment should serve to reassure the investor.

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