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# "SUBJECTS FOR ACCOUNTING RESEARCH"

ADDRESS

of

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SUBJECTS FOR ACCOUNTING RESEARCH

Professor Sanders has asked me to discuss principally the question of the subjects to which accounting research may most profitably be directed. To my mind, such a topic must be subdivided into what may be termed long range possibilities and into what may be thought of as promising, immediate subjects.

I believe it would be wholly unsound to formulate a program for immediate research without first having canvassed the field to determine what the ultimate objectives of the research program are. To express this in another way, it seems to me that there are a number of fundamental problems, including some widely accepted conventions or principles, which need reexamination and which are far reaching in their influence on accounting ways of doing things and thinking about financial transactions and events. These are pertinent topics for a long range study. On the other hand accepting the modern financial statements largely as they are found today, a good deal can be done in ironing out wrinkles that have appeared and in adapting accepted ways of doing things to novel situations that have become recurrent.

I want first to speak of some fundamental concepts. It is not criticism to point out that accounting developed as an instrument designed to aid managers in determining how best to conduct their affairs, in competition with other managers, so as to obtain their share of capital and credit as well as business. These managers were largely owners, or personal agents of owners. This is still one of the principal functions of accounting. With the growth of public investment in business and the divorce of ownership from control, however, it became necessary for managers who were not owners to report to investors who were not managers and had not the intimate knowledge of managers. At hand, for this purpose were the internal reports prepared for the management, which, when condensed, were accepted as an adequate means of transmitting information. Consequently, the report to stockholders took the form in most instances of a drastically abridged edition of the report to the management and often conveyed little of the information so essential for an intelligent investor's understanding of the activities of the business. Subsequent development has been mostly along the lines of additional disclosure and consistency of treatment. I doubt whether anyone has reexamined from stem to stern the whole philosophy of accounts and accounting practice with but one thing in mind, the interests of public investors.

Much effort has been expended with the object of determining what is correct or sound accounting. On the other hand, some have urged that the soundness or correctness of an accounting practice is determinable only on the facts of the particular situation, that circumstances alter cases. In this view of the problem, the point at issue is what are the relevant facts, for presumably in identical cases different conclusions are not possible. Under either approach, the time has come when the effect of alternative accounting practices on the interests of public investors must be given explicit consideration before reaching a decision. It is not to be implied that bringing the investors' interests into a position co-equal with that of management or the taxing authority will result in wholesale changes and radical innovations in accounting methods. Instead, it represents the introduction of an additional independent approach – whether the problem at issue be the formulation of accounting theory or the determination of the best way to interpret a particular set of facts.

So far I have had reference only to accounting principles and the appraisal of alternative procedures, such as depreciation and retirement accounting, the treatment of discount on refunded issues, the basis of valuing various assets, and the allocation of income and expense to various periods. The same considerations apply to the methods of reporting information. Today, inclusion in financial reports of a balance sheet and income and surplus statements is accepted practice. There have been many advances in disclosure, such as greater breakdown of major captions, separate display of reserves, and more information in the income statements. In some instances other statements are included such as computations of net asset values in the case of investment trusts, historical records of earnings, summaries of changes during the year, and the like. It may well be, however, that giving full play to investors' interests might lead to major changes in the traditional statements or to new forms of statements.

Merely to illustrate the possibility of research along these lines I may raise the question of the net worth section of the modern balance sheet and of what information it is supposed to give. As to the amounts placed opposite the individual capital stock items the ingenuity of the financial advisor and draftsman has added to the confusion caused by the introduction of no par stock and the further complications of paid-in surplus on either par or no par stock, the anomaly of a liquidating preference bearing no logical relation to the par or stated value of the issued shares or to the amounts received for them. In some cases we have the situation that by statute or charter provision, directors may on their own initiative utilize paid-in surplus to cancel particular losses or deficits or parts of them. Some urge that ordinary dividends may be charged to paid-in surplus although an earned surplus exists. Under these circumstances what becomes of the accountant's conventional distinction between capital and income? Further, the usual display does not distinguish between a company that has had large earnings and declared large dividends out of them, and one that has made small earnings. It does not indicate the extent to which stated capital is composed of capitalized earnings. It does not indicate how much as been paid in by investors or the extent to which invested capital has been changed by sale of new issues or by retirements and repurchases. It does not ordinarily give any indication either as to legal dividend limits or as to the extent to which dividends are financially advisable or possible; indeed the argument is often advanced that it is immaterial what surplus account is charged for particular losses since both are available for distribution. Finally, the mere existence of the net worth section in its present form tends to some extent, whether intentionally or not, to give an air of certainty and precision to the statements that is hardly justifiable judged by the amount of estimate and opinion that is interwoven into their preparation.

Is it not possible that research with investors' interests in mind might lead to a quite different presentation? Without recommending it one possibility occurs to me. Would it not be feasible to delete the detail of the net worth section from the balance sheet and replace it with some single balancing caption referring to a supporting statement? Then in the latter statement would it not be possible to show the aggregate beginning balance of the proprietorship analyzed to show invested capital, by classes of securities, and surplus sub-divided to show its origin. Items affecting each of these categories during the year could be shown and appropriately described. These statements might then be prepared in such a way as both to reveal the legal availability of surplus for distribution, and also reflect the accountants concept of the difference between capital and income. To add such a statement in a summary form for the period since organization or by significant periods would perhaps complete the picture. In any case agreement upon what the net worth section is to show seems essential as a starting point for consideration of the propriety of charges and credits to capital and earned surplus.

It is frequently urged that the division of corporate life into arbitrary one-year periods, or in some cases into temporary quarter-year periods, increases the degree of probably error in reporting results and tends to over-emphasize temporary tendencies, whether good or bad. Should not accounting research give thought to the desirability of summary statements covering a sufficiently long period to minimize inaccuracies of this sort and perhaps to illustrate more accurately the long term business results. The summary of net worth mentioned might be one such statement; a profit and loss statement covering three, five or ten years or more, another. Such summaries are not necessarily substitutes for the detailed statement, for by necessity they conceal the resiliency of the business to temporary conditions.

It is not to my mind a conclusive argument to say that an interested person may obtain past statements and compile results for such periods as he may wish. Nor is it an argument to say that these are problems not for accountants but for statisticians, economists, and analysts. After all, one of the major end-products of accountancy is the set of financial statements, the written story of the business, which the accountant certifies in his opinion fairly presents the condition of the business and the results of its operation in conformity with generally accepted accounting principles. It seems to me that accountants are perhaps the best qualified of all to mould the form in which accounting information is to be presented. Additionally, if accountants are to acknowledge a responsibility to the public investor, are they not therefore obligated to give their best efforts toward designing and insisting upon statements that will best impart the significance of the company's financial history and condition as to which the accountant in his certificate is to express his opinion.

Another topic for long range study springs from the fact that business transactions and business events are complex and do not always permit of the clean cut, precise classification of the natural scientist. This invites the question, to what extent may transactions be related to one another for the purpose of determining their proper effect on the accounts? In other words, for the purpose of entry in the accounts, what constitutes a "transaction"? If stockholder A buys a $100 par value share for $110 and B a share for $90, should both premium and discount be shown, or neither? Is there a difference if A buys both shares, but several days apart? May a parent company "donate surplus" to a subsidiary to absorb a particular loss leaving earned surplus undisturbed? Where the loss was due to over-valued assets received for stock issued to the parent our answer was yes. Is the solution the same when there are no others interested in the subsidiary as when there is an issue of preferred stock in the hands of the public? Cannot write-offs of write-ups be made without regard to earned surplus? Is this true if the revaluation surplus has been capitalized or otherwise disposed of? Is the time interval significant?

This problem has not, I think, received extensive explicit consideration although its elements appear in nearly every argument. Generally speaking, when it is desired to group two or more events, the justification given is “identity” in one form or another: Such as in time, in the persons involved, or in being direct results of a preceding transaction.

In the field of valuation somewhat the same question may often appear. In applying cost or market, whichever is lower, to inventories much attention has been directed toward securing its application to individual items. Perhaps not so much has been given to consideration of what constitutes an “item” although by variation of the classification widely different results may be obtained. Without stating all of the factors necessary for precise consideration, the following example may be provocative. If a company has on hand five lots of goods, cost or market might reasonably be applied in any of the following ways: To the aggregate, if considered to be of the same description; to each lot, if considered different; to some grouping of these lots based on similarity; to the aggregate or in some grouping of lots, although of different classes of goods, because purchased in a “deal” from particular vendors.

In another direction, it is generally assumed that forgiveness of indebtedness, or its repurchase at less than face, represents a credit to income or earned surplus, at least in the case of a solvent company. But suppose the debt was owed to a sole stockholder, or a parent company and created by declaration of dividends from paid-in surplus? Suppose again that earned surplus has been transferred to capital stock or to paid in surplus. If the entire class of stock were later redeemed or repurchased at less than its book interest, could any excess of the amount previously transferred over the repurchase price be then returned from capital stock or paid-in surplus to earned surplus?

I believe that the elements of this problem will be found to be present in a very wide sector of accounting thought. It has been explicitly discussed as a problem in itself in one or two instances. It has often been dealt with as it affects particular problems. Its omneity suggests it as a suitable topic for research, with the understanding that research may well show it to be merely the result of other considerations rather than an independent factor to be separately appraised.

In summary, I have suggested as possible long range objectives of accounting research, first, the definite consideration of accounting principles and procedures to determine what their effect on public investors is and what procedures and principles the interests of public investors would require to be followed; second, a reconsideration of the technique of financial reporting to public investors, with special emphasis upon the net worth display, and third, consideration of the bases upon which transactions and events may be grouped in determining their effect on the accounts.

In addition to such problems, there are many questions of importance that appear, at first glance at least, to be soluble for practical purposes without the long study necessary for the more pervasive problems. There are, I think, a large number of instances in which conflicting methods have received support under circumstances that result in confusion and invite criticism on the part of the layreader if not the trained accountant. These problems are not simple, nor is it contemplated that they can be wisely solved without careful investigation, consideration of opposing views, discussions and conferences. Rather they represent areas in which controversy may be localized. In many cases, the arguments for each method have been assembled and criticized to the point where new considerations seem unlikely. The status of the argument is often such that any one will be recognized by all as acceptable, possibly with the requirement of disclosure of the method followed. And these varying theories are applied to situations in which if basic differences exist, they are not apparent.

Fortunately, I do not conceive it the part of this paper to express opinions on the problems presented, except possibly as to their importance, and for that reason I shall proceed with a mere summary statement of topics in this category.

To begin with there is the question of whether, and if so, how, the appreciation of permanent assets already on the books should be reflected in the accounts and statements. Resulting credits are of so special an order that it would seem basic to require their segregation if not their exclusion from the surplus accounts. If the representation of appreciated assets is to be made, should there not be agreement as to what necessary results must follow in computing and providing for both annual depreciation and accumulated reserve credits? Of a somewhat similar nature is the question of permanent investments in controlled companies. The question of whether the net equity or the cost method should be followed would seem to be soluble. If the equity method is used at all, the proper treatment of profit credits in the income and surplus accounts seems susceptible of a positive solution. If the cost method, the question of allowing for losses of the subsidiary must, I feel, be agreed upon. Is it proper as a recent case indicated to carry an investment at $1,000,000 when the equity of the parent was minus $700,000 and the subsidiary's operations were increasingly unprofitable?

Question is frequently raised as to how cumulative dividends on the minority preferred stock of subsidiaries should be handled. The trend is doubtless toward allowance in full in the consolidated statements. Ardent supporters can be found, however, for the position that these are to be deducted in the income statement only to the extent earned, the remainder to be cared for in various ways or not at all. Treatment of such dividend requirements on the books of a parent following the equity method is a closely related problem. This, of course, is but one special point in the much larger, and more intricate question that is sometimes referred to as the principles of consolidation. In addition to the special problems peculiar to this device, the majority of the problems found in individual statements are found also in consolidations and their solutions have to be reconsidered. Even such elementary questions as the treatment of dividends from current profits in the face of a deficit since acquisition have caused difficulty – due to the existence of the Federal excess profits tax.

Another problem that would have had to be added to this list but for the strong position recently taken by your Institute is the method of treating gains upon sale or retirement of treasury shares. Despite this release there remains the analogous problem of the treatment of these differences when the purchase price is more than the amount paid in by the security holder. While any amount paid to the company in excess of par or cost as the case may be can clearly be characterized as a net payment by a stockholder, there is not the same clarity of circumstances when the amount paid by the corporation exceeds the amount paid it by the stockholder. Particularly if there is no capital surplus allocable to the shares in question is there not room for argument that the extra payment is in the nature of a distribution of earned surplus. A related problem which has been the subject of some discussion and correspondence with a committee of your Institute as well as others is the case of the retirement of a whole issue of preferred stock at an amount in excess of the sum paid in by those stockholders as a class. Neither of these questions may be finally soluble until agreement is reached as to the concepts of earned and capital or paid-in surplus and as to the extent to which surplus resulting from payments by one class of stockholders may be used to absorb charges resulting from payments to another class.

Likewise when a careful examination is made of the method of setting up information in the statements themselves there are still instances in which alternative treatments are found, representing not basic differences in fact but a personal predilection of the draftsman. In some cases, methods are followed which appear inconsistent with recognized accounting principles - as for example the treatment of purely valuation reserves otherwise than as a deduction from the assets to which they apply or the carrying of treasury securities as an asset. If as your Committee has announced it sees no difference between, on the one hand, the purchase and resale of a company's own common stock and, on the other hand, the purchase and retirement of a company's own common stock and the subsequent issue of new common shares, there seems to be little ground for distinguishing in the balance sheet position of unissued and treasury shares.

A similar problem that has been the subject of much controversy and which is, I believe, being actively considered at the present time, is the disposition to be made in the statements of items clearly affecting the operations of other years, of items of a non-recurring nature that do not affect the operations of any one year but which because of their erratic appearance and fortuitous nature can neither be foreseen and provided for nor properly deferred, and of items which represent recoveries of allowances and charge-offs of prior years. To add to the difficulty, particular items in this group often may be placed in two or more of these categories. The arguments are fairly clear cut. Some say all items should be handled through income, others that the final figure on the income sheet should be the balance of items clearly affecting the operations of this period, still others that original allowances or write-offs should appear in the income sheet but that recoveries and unusual profits cannot be used to improve the current showing or earnings. Others believe if the items are particularly significant, that the income statements of the years affected should be recast and published anew. A final group feel that the position of the item is relatively unimportant provided both the income and the surplus statements are clearly drawn up and prominently displayed. To some extent these differences are the result of variant views of the accountant's concept of income. To some extent, they are influenced by an appraisal of the effect of the various methods on the investor. In either case, it would appear that agreement is not an impossibility.

The final group of problems that I wish to mention taxes the ingenuity, logic and creative ability of the accountant more than any other. These are the problems resulting from new ways of doing business and from new economic conditions. As novel problems arise it becomes the task of the accountant to determine how the new conditions are to be reflected in the accounts. One of the most pressing of these from our point of view has been the corporate phenomenon which I have elsewhere termed a quasi-reorganization. Last December I had occasion to outline some of the more common situations of this character that have come to our attention and indicated some of the conclusions we had reached. Recurrence of the situation has made a wide variety of cases available and has indicated the need for a good deal of further study of the matter. The problem is sufficiently new that some of the major issues have not been widely considered or settled. At the outset there is the question of consent. So major an interruption of the continuity of the accounts warrants a requirement of consent thereto by the shareholders, after adequate and specific notice of the proposals. But the issue remains as to whose consent--need it be given only by the common shareholders, only by the holders of shares entitled to vote on matters of general corporate policy, or is it requisite that the non-voting stock be polled since the interests of these classes may well be vitally affected. Indeed, if it is not heretical, I may suggest that often bond holders may have an important stake in the disposal of the question, since the presence of a deficit may enforce retention of future profits while its elimination would remove this barrier. If the presence of a specific statutory provision enables the directors on their own initiative to eliminate such a deficit in part or in whole *for dividend purposes*, there is the further question of whether this should prevent application of the requirement of consent – that is, whether such a statute *alters the concept of earned surplus*. If not then as a minimum, exception and lucid explanation appear to be required.

The second major issue is whether it is necessary, as a corollary to the elimination of a deficit by this procedure to take into the accounts profits as well as losses which may be so to speak "inherent" in the assets but which are not recognized as "realized" by accounting principles and conventions. The spectre of large credits to earned surplus after the readjustment arises at once – credits representing in whole or part, for example, the difference between market values and carrying values at the effective date. Closely connected with this problem is the question of whether, if assets have been stated at estimated "fair values" corrections of the estimates are permissible or required as of a subsequent date, with resultant alterations in the balance of capital surplus and the amount of the deficit written off. An example of the more abstruse difficulties sometimes encountered may be in point. A company had been in the custom of deducting in its consolidated profit and loss statements unearned but cumulative dividends on the preferred stock of subsidiaries outstanding in the hands of the public. The contra entry increased the minority interest shown on the consolidated balance sheet. Subsequent to a quasi-reorganization it had acquired some of the subsidiaries' preferred shares. Accumulated but unearned dividends having thus been cancelled, the question arose whether in the consolidated statements the cancellation of these dividends should not be reflected by transfer thereof from the minority interest to consolidated earned surplus. Analysis indicates that the deficit written off was made larger by the provision for unpaid and unearned dividends. The proposed entry would in effect have transferred deficit before the effective date to earned surplus after that date. But if the minority interest was correctly reflected at the effective date, is not the difference a "profit" resulting from events subsequent to the effective date and therefore an appropriate constituent of earned surplus? Or is this, from a consolidated point of view, only a dealing the one's own stock?

A research organization, particularly one such as that of the Institute with ready access to both practicing and research accountants can, I believe, contribute materially to the solution of the vexing array of old disputes and new problems that are constantly arising. If its efforts toward solving these localized controversies are complemented by long range consideration of the more pervasive problems such as surplus and valuation of inventories and other assets and by study of the best means of satisfying the continually increasing demands upon accountancy by the investing public its activities will become indispensable.

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