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REPLACEMENT COSTS AND DEPRECIATION POLICY

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The purposes for which accounts are kept by corporations have changed radically during the last thirty years. Prior to World War I, most corporate securities were held by persons who did not have to rely on published reports for the information they needed for their investment decisions. Those who were not in that position were so few in number that most companies ignored them, and published data usually consisted of a very condensed balance sheet and little or no facts as to income.

During the 1920s, quite a shift in corporate ownership took place. Large numbers of relatively small investors came into the market. Corporate stocks and bonds in most of the large corporations became so widely held that only a relatively small number of shares could control, yet corporate reports were not radically improved. Then came the stock market crash and the depression. The public decided that investors had not been receiving enough facts and, rightly or wrongly, concluded that inadequate information had been the cause of their investment troubles. Thus, because the public investors' rights and needs were ignored in the '20s, the pendulum swung sharply and we got the SEC.

We are now facing demands for information from a

different group. This time from labor. It is important that business should examine labor's demands and see that its real needs are met effectively before some major event again precipitates legislation far more drastic than will be necessary if business will act voluntarily.

Recently the consumer has begun to voice an increasing interest in the results of business operations. How far this may go no one can tell. There is much evidence of growing opinion that the public has an interest in prices and business practices that goes far beyond the public utility area to which it has been chiefly directed in the past.

The time has long since passed when the financial information with respect to a company whose securities are substantially held by the public can be kept close to the management's chest. It may not be long until the same may be said of companies employing a substantial amount of labor or selling a product that is highly important to the public.

When such large segments of our voters have an interest in corporate financial information, there can be no doubt that they have adequate political force to back up their demands for what they think they need. That being the case, business has no alternative but to see that those who really need such data can get it. An imperative part of such a program is that the published statements purporting to furnish such information be accepted with complete confidence in their fairness and the adequacy of their disclosures. If any substantial public suspicion as to the reliability of such information

should develop, it requires no crystal ball to know that sooner or later--and more likely sooner than later--severe steps will be taken. Wholly apart from any sense of morals or of public responsibility, purely selfish reasons dictate that those now in charge of businesses so present the facts with respect to the enterprises under their jurisdiction, that the public will have such complete confidence in their reports that no substantial pressure for more stringent public regulation can develop.

Because of the methods by which accounting procedures have historically developed, substantial areas of differences in procedures have grown up. Often these differences have been sufficient to prevent comparisons between companies and sometimes they have led to confusion in the interpretation of the reports of individual companies. It seems obvious that these differences have been responsible for much of the criticism of published financial information and for a great deal of the suspicion of corporate financial statements. They also afford a basis for attacks on business by those whose purposes are more devious. Nine years ago, the American Institute of Accountants, the national organization of practicing certified public accountants, undertook a major program directed toward the reduction of these differences. It created a major committee, called the committee on accounting procedure, to examine controversial questions in accounting and to recommend procedures to be followed in the hope that the areas of difference would be reduced and published statements would be made more useful. To date this committee has issued 31 bulletins, most of which

have dealt with some problem that had proved troublesome and confusing. These statements carry only the weight of their own reasoning and the reputation of the members of the committee, but they appear to have made important gains in the direction of reducing some of the major differences in accounting procedure that had been the cause of so many criticisms of financial statements.

One important area of difference which has developed only recently is in the field of our subject for this afternoon, "Replacement Costs and Depreciation Policy." Business men are asking what can be done to prevent corporate capital from being depleted because construction and equipment costs are now so high in comparison with prewar costs. Obviously, if present costs continue it will be necessary to replace existing facilities at considerably more than their cost. That will require that additional capital be tied up in plant and equipment. Additional capital can come from only two sources--retained profits or additional investments.

Business often seeks new capital for expansion but it is usually an evidence of weakness if it has to do so merely to hold its own. Nevertheless, there appears to be considerable reluctance to report the profits that are needed to provide enough funds to replace plant and equipment at high price levels. Stockholders are hard to convince that increased profits should not be distributed as dividends; labor increases its claims for compensation; political demagogues harrangue on the excessiveness of corporate income; and enemies of our political order use it to stir up prejudices against private

enterprise.

To meet this difficulty, companies have been seeking methods whereby they may in some way recognize the present high price level for plant and equipment as part of the cost of doing business currently. The certified public accountants are very sympathetic with the motives back of these procedures. Furthermore, they do not believe that an accounting procedure must be ruled out merely because it has not been recognized in the past. However, they have long ago learned--and most thoughtful business men agree with them--that if an accounting procedure is to be useful to those who rely upon published financial statements for their information, it must be such that the results can be tested objectively, within reasonable limits, and it must be followed consistently from year to year.

Accounting concepts have not been developed by the whim of accountants or by contemplation in ivory towers, as our critics sometimes profess to believe. They have been developed by long experience and adopted because they best serve the broadest needs of business. It follows that they should not be discarded hastily. However, basic assumptions underlying these concepts must be surveyed constantly if financial statements are to be increasingly useful as sources from which to draw conclusions affecting economic, social, and political judgments. The implications of financial reporting are constantly broadening and our economic stability is greatly affected by the influence of financial statements. This is particularly true with respect to income statements. Whenever,

as now, question is raised as to whether a major business need is being served adequately by existing accounting procedures, it is important that we determine whether the weakness lies in the accounting procedures or elsewhere.

The problem currently before us must be carefully scrutinized and its significance and importance to business today fully recognized, but it seems obvious to start with that the answer does not lie in any scheme of arbitrary charges unrelated to the past or the future and designed only for the exigencies of the moment. Neither does it lie in a program to be applied only by companies having large current profits. For the best interests of business as a whole, accounting must be an orderly process and should result in reasonably consistent practices.

There can be no argument but that a going concern must be able to replace its productive assets as they are used up if it is to continue to do business. It is also important for management to understand that the difference between cost and estimated replacement value may be significant in determining production and pricing policies. It does not follow, however, that the excess of the cost of replacement over the cost of existing assets should be accounted for as current charges to income. All who have dealt with appraisal values know how very difficult it is just to determine current replacement costs, but the most striking difficulty in this respect is the impossibility of predicting what will be the eventual cost of replacing a productive asset. How many are

prepared to state what the price level will be two years from today, to say nothing of trying to guess what it will be five or ten years hence when many of these assets are to be replaced? To further complicate the problem, productive assets are not generally all replaced at the same time. Most plants are made up of assets having varying life expectancies and the price levels are not at all likely to be the same in the several years in which these replacements are to be made. Accordingly, it would be necessary not only to guess the price level in a particular future year but to guess what proportion of the facilities are likely to be replaced in that year. Price levels may rise and fall and rise and fall again before many of these assets will have to be replaced. Then again, very few facilities are actually replaced in exactly the same form. Processes and products are often so changed that the same type of equipment is no longer the most suitable.

One of the most fundamental accounting concepts and one which has been found to be of the greatest usefulness to business is that the cost of productive facilities, such as those under consideration, having a long useful life must not be charged to the year in which the facilities are acquired but spread over the fiscal periods during which they are expected to be useful. Their costs are treated as deferred charges to future operations to be allocated to the fiscal periods expected to be served. It has also been long recognized that the purpose of depreciation accounting is to allocate cost of existing facilities, not to provide funds for replacement.

It is well understood that considerable judgment has to be exercised in the application of accounting principles, but judgment is expected to operate within the limits of accepted criteria. It seems pertinent to ask whether there are any such criteria covering the types of charges that have been advocated in connection with the recognition of current replacement costs. If not, and I know of none, it would appear that until appropriate criteria have been developed that can be consistently applied generally, we have no alternative but to refrain entirely from such charges. Business is not well served by a wide variety of practices being followed by various companies. If it is proper for a few companies to make additional depreciation charges to income on the grounds that those based on cost are inadequate to provide full replacement funds, there are undoubtedly many others that should do likewise. In the absence of reasonable criteria to govern such charges, it is difficult to see how this can possibly be brought about.

On September 25th of this year, the committee on accounting procedure, after considerable correspondence and an extended discussion, issued a statement of its views on this subject. Subsequently this statement was published in the October, 1947 issue of The Journal of Accountancy. It reads as follows:

"The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the

price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.

"The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of 'inflated' dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.

"When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

"It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar

is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

"It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

"The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness."

These conclusions were reached on grounds that seem basic--for example, because "there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income," because "the significance of

recorded amounts of profit might be seriously impaired," and because they "would not increase the usefulness of reported corporate income figures."

I would not want to close this discussion without paying my respects to the argument that has been advanced that depreciation on current replacement costs of facilities is equivalent to the last-in first-out or LIFO method of accounting for inventories. LIFO is a method which was developed to match current inventory costs against current revenues. As originally developed it constituted an assumption as to the flow of goods in certain industries, but as it has been more recently applied it must be considered to be a theory of cost allocation. Nevertheless, it is an orderly procedure which, once adopted, can be consistently followed thereafter, can be objectively tested and can be generally understood. Perhaps some procedure can be developed that will more nearly relate current prices of fixed assets to current revenues, but it seems obvious that last-in first-out is not the answer. The factors are not present for its use. Under the theory of LIFO, goods sold are charged out at a cost that has actually been incurred for some that were acquired during the year. The procedures that have been advocated for charging costs of fixed assets can not be related to any actual costs. They are not designed to charge the latest costs of facilities into expense. Instead they contemplate a charge based on the cost of facilities not yet acquired. Someone has appropriately dubbed this the NIFO method--next in, first out. Its effect

may have some of the same effects that LIFO has for inventories, but it seems to be highly unrealistic as a possible procedure to meet this problem.

Perhaps, after all, the solution to this problem is not to be found in changing accounting procedures. Maybe basic business concepts of profits are at fault and rapidly rising or falling price levels merely bring out the need for different ones. Perhaps we should develop a system of measuring business activity in terms of index numbers. Possibly existing accounting procedures would be most effective for reporting basic data if a plan for measuring profits in terms of constant units of value were developed and supplementary statements in terms of such a constant unit were adopted. Until some basic change in business measurement or some sound change in accounting procedure can be developed to meet these current difficulties, however, we must resist the adoption of procedures that have no basis for objective determination and are not intended to be applied consistently. Certainly the answer to our problem is not for companies to decide their procedures without regard to the need for orderly and consistent practices. Business as a whole will suffer if there should be any widespread feeling among the users of financial statements that charges to income are based on the whim of management, are not in accordance with generally accepted accounting procedures, and cannot be tested for fairness within reasonable limits.