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Idiosyncrasies of Accounting*

By Stanley G. H. Fitch

The subject announced for this evening, "Idiosyncrasies of accounting," was not of my own choosing. It was chosen for me by your president after I had accepted his cordial invitation to speak before the Providence chapter of the N. A. C. A. on a subject to be announced later. Your president fulfilled his part of the arrangement by announcing the subject, but he failed to let me in on it until after your chapter's otherwise very excellent program for the year 1934–5 was printed.

Being of a cautious nature, one of my first moves was to consult the dictionary so as to define the scope and limitations of my subject. Here is what, to my surprise and consternation, I found:

"Idiosyncrasy—A peculiarity of constitution or temperament; a characteristic distinguishing an individual; eccentricity."

Analyzing that definition of idiosyncrasy, I questioned whether accounting had a constitution or a temperament, and whether accounting could be held to be an individual. I resolved all these questions in the negative and decided that the subject had been purposely framed so that my assignment would be impossible of fulfillment and that, after all, Mr. Over had chosen a delicate way of easing me out of the program to make way for some eminent headliner of greater drawing power than my humble self.

Upon further reflection, however, I concluded that I wouldn't let your president get away with anything like that, because some of my Boston chapter friends had seen your program and if they discovered later that the speaker had been changed it would be most embarrassing to me to try to explain my failure to show up.

Looking at the matter calmly and dispassionately, it seemed to me that idiosyncrasies of accountants (not accounting) would make just as good a subject as the one that had been selected for me. It would even meet the specifications in Webster's: Accountants are all individuals; each one has a constitution or temperament more or less peculiar; and some, without doubt, may be classed as eccentric.

*An address before a joint meeting of Providence chapter of the National Association of Cost Accountants and the Rhode Island Society of Certified Public Accountants at Providence, Rhode Island, April 15, 1935.

Having once been called upon to write a report for a client who subsequently criticized my inability to stick to my subject and bluntly told me I had tried to answer some questions he hadn't asked, I was finally inspired to draw upon this experience and write around the subject assigned, with the hope that my hearers would not be so caustic in their remarks as my client had been, even though I might fail, by verbiage and subterfuge, to distract their attention from the main theme supposed to be under discussion.

I

During my experience of more than thirty years as an accountant, most of which has been in the field of public practice, the idiosyncrasies of other accountants (I exclude consideration of any of my own which I unwittingly may possess) including cost accountants, public accountants and some not classifiable in polite language, have aroused in me emotions ranging from innocent enjoyment to aggravation and even desperation. In the discussions (sometimes arguments), that have ensued, my views no doubt seemed as peculiar to my antagonists as did theirs to me. As the years roll on, however, a better understanding of the methods and objects of cost accounting and of the principles underlying the presentation of financial statements in annual reports to stockholders, bankers and governmental authorities smooths the path of all accountants and tends to obliterate the idiosyncrasies in all except the few irrepressibles who will always be with us.

To recall a few cases from my experience may, I hope, sustain the interest of my hearers, although in doing so I hope I may be pardoned for too frequent use of the first person, singular. If I am subject to criticism for this, my only answer is that I found it awkward if not impossible to tell the story in an impersonal way.

In planning a cost-finding system, how are you going to satisfy a client who buys a plant and inventory of raw material at receiver's sale for 10 per cent. of their original cost, who refuses to charge off any depreciation on plant because he says it is already valued at too low a figure on his books, who wants to revalue the inventory at market to improve his current ratio for balance-sheet purposes, who insists that the material used be charged into production cost at the knockdown price he paid for it? Which of us is idiosyncratic?

Not long ago I presented certified financial statements to be submitted in an annual report to the stockholders. The comptroller was a young man of great energy but limited experience and published the report without first showing me the proof. To my consternation I found that no reference was made in the printed statements to a contingent liability which appeared on the original balance-sheet. When I protested at the omission of a material statement the comptroller's answer was that he considered himself fortunate to be able to print all the figures—there wasn't room on the printed page for the contingent liability.

A certain manufacturer, hard pressed by his creditors who had insisted upon an audit of his accounts, delivered a scathing rebuke to me when I questioned his basis for valuing his inventory. Much of the inventory was two to three years old, obsolete and unsalable, but valued at cost plus interest at 6 per cent. per annum from date of purchase. The old gentleman refused to hear my mild protest that the value of merchandise did not, in my opinion, like good wine, increase with age. Shortly thereafter for obvious reasons the business folded up.

In contrast to the foregoing experience I remember with keen appreciation the native shrewdness of a certain New Englander, who, on my first visit, kept me severely at arm's length and expressed considerable annoyance because my report included substantial liabilities omitted, perhaps unintentionally, from the books at the closing date. Nevertheless, being a broadminded man, he sent for me again at the end of the next fiscal year, but to my surprise said that the books would be ready within a week after the closing date, relatively earlier than the year before. He subsequently admitted when we had become good friends that he thought his plan for an early start and prompt finish might preclude any auditor's adjustments, but his bookkeeper had gained in experience and there were no adjustments of any consequence to be made.

The fear, sometimes felt by the layman and perhaps not founded on experience, that public accountants have been prone to unload too much system on a small enterprise is illustrated by the following case where I was fortunate enough to be able to dispel such fear from the mind of at least one man. After I had completed the examination of the accounts of a suburban school district and outlined a system under which current monthly expenditures could be readily compared with the appropriations,

the treasurer expressed surprise that the desired results could be obtained so simply, when he expected me to produce a so-called complicated system of accounts.

II

Whether or not the result of idiosyncrasies of accountants or others, accounting for plant values in the last ten years has undergone at least two changes of heart. During the boom years when costs were advancing, plants were commonly written up to replacement values or other higher levels, and the resulting appreciation was carried to capital surplus or perhaps capitalized. In some instances depreciation on the total appreciated value was charged against earnings; in others, the charge for depreciation on the appreciation in value (or on the amount written up) was deflected into capital surplus so that earnings might not be adversely affected. That procedure was based on the theory that the books and balance-sheets should show going values for plant, although it has been hinted that in some cases the write-ups were actuated by ulterior motives.

When the depression arrived, sentiment regarding the basis for plant values suffered an about-face. Where plant values had previously been written up, they began to be written down; plants rendered idle by lack of business were wholly written off and corporate capital structures were likewise scaled down. While under this procedure, stockholders suffered a severe shrinkage in their equities, the accompanying reduction in depreciation charges against operations placed the corporations in a more favorable position than before, as to future earnings and dividends. The year 1933 saw the climax of what an officer of the New York stock exchange described as a mass movement in the restatement of corporate accounts.

From the standpoint of some of our friends engaged in the practice of law, there appear to be many idiosyncrasies which we as accountants find it hard to reconcile with the legal concepts of a proper accounting presentation. Why, asked a lawyer, if surplus is represented by cash and other assets, do you show surplus on the liability side of the balance-sheet? To that question the answer was easy.

In the days of the federal excess-profits tax "invested capital" was of vital concern, for upon it was based the amount of profit exempt from that tax. Many corporations restated their plant

accounts in order to increase the surplus by restoring excessive depreciation or maintenance charges made in accordance with the conservative ideas of accounting which were common before the war. In discussing this subject with a client's counsel, he pointed out that the revenue law defined "invested capital" in substance as the sum of capital stock and surplus. "How then," said he, "can you increase 'invested capital' by building up an asset account?" He grasped the situation promptly when it was explained that the amounts to be restored to plant values would necessarily also be restored to surplus.

The legal and the accounting attitudes toward the treatment of treasury stock involve idiosyncrasies perhaps on both sides. It has been held that in certain circumstances treasury stock is neither a liability nor an asset. If that is so, what is it? And where does it fit in the balance-sheet? It is important to remember that the various state laws relating to the rights of a corporation to acquire its own stock and the effect of such acquisition upon surplus available for dividends should be given careful consideration. Furthermore the purpose for which the treasury stock has been acquired, i. e., for resale or for retirement, should be carefully weighed. The proper treatment of the treasury stock on the balance-sheet, as an asset or as a deduction from capital stock, from surplus, or from the total of capital stock and surplus, should then be readily determined.

III

If accountants are subject to idiosyncrasies in their professional work, what can we say of our federal tax-law makers who set out every few years to simplify the federal revenue acts and each time enact a law in many respects still more complicated and difficult of interpretation and administration?

Consider the revenue act of 1934 and some of its provisions for determining taxable income, which from an accounting point of view are unique. That act provides that gains and losses from sale or exchange of "capital assets" by a taxpayer, other than a corporation, shall be taken into account on a percentage basis according to the length of time he has held the property, as follows:

(a) 100 per cent. if the capital asset has been held for not more than one year.

(b) 80 per cent. for more than one year, but not more than two years.

(c) 60 per cent. for more than two years, but not more than five years.
(d) 40 per cent. for more than five years, but not more than 10 years.
(e) 30 per cent. for more than 10 years.

Thus it is quite evident that this provision is intended to limit the deductible losses on sales of assets acquired during years of high prices, although, during the years of the bull market, profits on similar transactions were taxable in full.

Further than that we have the capital-loss limitation, which provides that "losses from sale or exchange of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges." In other words, if the computed capital losses amount to $20,000 and the computed capital gains to $4,000 or a net computed capital loss of $16,000, only $2,000 of such loss may be taken in the taxpayer's tax return and he is deprived of any tax benefit in any year from the loss of $14,000.

In the case of corporations, the graduated percentage of reduction of capital gains and losses does not apply, but the loss limitation from sale of capital assets ($2,000) does apply to corporations. On the other hand, loss on the abandonment of a capital asset is deductible in full. Therefore a corporation may find itself in the incongruous position where the saving in tax by abandonment of property may exceed the amount which might be received if the asset were sold.

While the federal revenue acts have contained many features that did not square with sound and accepted accounting practice, every act since 1917 granted to affiliated groups of corporations the option of filing consolidated returns, in line with the practice of such groups of corporations in reporting to stockholders on a consolidated basis, inter-company transactions being eliminated and the net consolidated profit or loss of the group being regarded as an equitable basis for taxation. The act of 1934 denies the privilege of a consolidated return to all corporations except railroads and has caught individual corporations with taxable income for 1934 while others in the same group reported net losses, hitherto offset in consolidated returns. In due time, unless the consolidated feature is restored to the revenue act, for which there is now strong sentiment, it may be expected that by rearrangement of corporate relationships, taxable income on the aggregate of

individual returns will approach the result attainable on a consolidated basis.

Following the enactment of the 1934 revenue act, and as a compromise measure to reduce if possible the allowable deductions for depreciation, came treasury decision 4422, which placed upon the taxpayer the full burden of proof to show that depreciation claimed was reasonable, based upon the useful life of the assets. In computing the depreciation reserve in respect to any asset the requirement is that for each year the reserve shall include the greater of depreciation allowed (in the tax return) or allowable (even if that was not claimed in the return nor recorded on the books). Obviously a depreciation reserve so computed will not agree with either the depreciation reserve resulting from the treasury department's own allowances for prior years or the reserve on the taxpayer's books.

While I have mentioned briefly a few of the provisions of the federal revenue act, which require special accounting consideration, and have implied that if accountants are subject to idiosyncrasies, the lawmakers are a contributing cause, in my opinion the grand prize for idiosyncrasies in accounting should be awarded either to the postmaster general for his masterful treatment of the post-office deficit, whereby he was able to announce a profit for the last fiscal year, or to the chairman of the house committee on ways and means, who recently was reported to have "hailed" the results of the March tax collections which he alleged put the federal government into the "black" so that no new taxes will be necessary. We, as taxpayers, devoutly hope that both gentlemen are right.

IV

A brief review of the developments in cost accounting and public accounting during the past ten or fifteen years may be admitted as a related subject, but it is impossible to do more than to mention a few of the outstanding accomplishments.

We have seen in the field of cost accounting the ever-increasing application of the principle of standard costs; the recommendation by trade and industrial associations of adoption of uniform methods of accounting by members; the intensive development of manufacturing and operating budgets; the active discussion by chapters of the N. A. C. A. of a wide range of subjects, varying from the mechanics of bookkeeping to management, marketing

and monetary problems, with speakers of national repute—industrialists, economists, governmental officers and professors from leading universities; and the publication of technical literature on cost accounting subjects, well exemplified by the bulletins and year books of the N. A. C. A.

Since the advent of the "new deal" the toughest job undertaken by cost accountants was the attempt to define "cost" for the various codes under N. R. A. in the endeavor to prevent selling below cost. In the *N. A. C. A. Bulletin* of December 15, 1933, a special committee report deals exhaustively with "Essential elements of cost for uniform accounting under the N. R. A.," and in *N. A. C. A. Bulletin* of January 15, 1934, Eric A. Camman presented an analysis of "Selling-below-cost provisions in industrial codes." It is not my purpose tonight to review those publications but to emphasize the point that only a few of the codes attempted to define cost, owing to the inherent difficulty of wording a definition that would be generally applicable.

Even if N. R. A. is granted a new lease of life by the congress, the desire to retain the selling-below-cost provisions in the codes seems to be waning. Nevertheless the time and effort that have been expended in undertaking to define "cost" have been well worth while in broadcasting the principles which underlie cost-finding for whatever purpose.

Developments in recent years in public accounting practice have been characterized by close coöperation between the national and state societies and bankers, corporation accounting officers, New York stock exchange officers and federal authorities, especially the securities and exchange commission.

Recognizing the importance of a standardized procedure in the preparation of financial statements for credit purposes, the American Institute of Accountants, at the request of the federal trade commission, in 1917, prepared a memorandum on procedure, which after approval by the commission, was accepted by the federal reserve board and published by the board in its bulletin in April, 1917, under the title "Approved methods for the preparation of balance-sheet statements." The bulletin received wide recognition from accountants, bankers and borrowers as the minimum requirement for a balance-sheet audit. After nearly twelve years' use a revision of the bulletin in some respects was deemed desirable and a committee of the American Institute of Accountants undertook that task. The revised bulletin was pub-

lished by the federal reserve board in May, 1929, under the title "Verification of financial statements."

Committees on coöperation with bankers appointed by a number of state societies and the American Institute of Accountants have held joint meetings with committees on coöperation with accountants appointed by the Robert Morris Associates. By frank and open discussion, they have cleared up many questions that had been raised regarding certified financial statements submitted by borrowers to their banks and reached a ground of mutual understanding on other matters that could have been attained in no other way.

The movement for more illuminating and informative reports by corporations, which had been gaining momentum in recent years, resulted in 1933 in definite requirements by the New York stock exchange in respect to audited financial statements to be filed by listed corporations. In January, 1934, the American Institute of Accountants published under the title "Audits of corporate accounts" the correspondence, during a period of a year and a half, between the special committee of the Institute on coöperation with stock exchanges and the committee on stock list of the New York stock exchange, wherein may be found a statement of certain important principles accepted as a basis for accounting by the reporting corporations and a form of accountant's report to accompany audited financial statements of such corporations, which carries the approval of the American Institute, the New York stock exchange and the Controller's Institute of America. The approved form of accountant's or auditor's report was widely adopted and appeared during the past year in the printed annual reports of many large corporations.

Another highly interesting recent publication is the report of the committee on statistical reporting and uniform accounting for industry to the business advisory and planning council for the department of commerce, entitled "Reports to stockholders." Included in the committee's report is a discussion of general principles, viz: nature of accounting statements, consistent application of principles, uniform accounting and reporting practices and the need for conservatism. It then covers, in thorough fashion, the analysis of balance-sheet and income statements. Finally the report endorses the approved form of auditor's certificate previously mentioned. The research secretary who wrote the committee's report was our friend Professor T. H. Sanders of

the Harvard business school, a past president of the Boston chapter and a past national president—and I don't need to tell you he did a good job.

In December, 1934, the securities and exchange commission released form 10, for permanent registration, under the act of 1934, of securities temporarily registered upon national exchanges, with a book of instructions which have been received with general approval by accountants and business men. The securities and exchange commission asked and received the advice of a special committee of the American Institute and also of other accountants. Here again our friend Professor Sanders comes into the picture, for he was largely responsible for writing those instructions. Then came form A 2 with instructions, for the registration of new security issues of seasoned corporations under the act of 1933. This followed closely the wording of form 10. It is, therefore, evident that real progress has been made in the direction of uniformity and standardization of requirements by the securities and exchange commission. The obvious procedure is for listed corporations to shape their annual reports in advance to fit the essential requirements of form 10.

V

Your president suggested that I should include in my remarks some reference to the relationship between the cost accountant in private employ and the public accountant whose work embraces not only cost accounting but auditing and other phases of accounting as well. A discussion of this topic, thought he, no doubt would uncover many idiosyncrasies of both classes of accountants, but I have already touched upon that tender subject and there is little more that I can say.

It is, however, unfortunately true that in years past there has existed to some extent an invisible barrier between the cost accountant in private employ and the accountant in public practice, for which neither group is to blame. I am glad to say that it is gradually being broken down through better understanding of each other's problems, fostered by such a meeting as this. For example: before I entered public accounting, I held a job as auditor of a manufacturing concern and my duties included those of cost accountant. In the course of time, a change in management occurred and the newly installed heads called in a firm of public accountants to overhaul the cost system, without first

trying to find out how good the system was or how much the then incumbent knew about it or the details of the business. Being human, I cherished some resentment against the intruders, although they were not personally to blame, but eventually I derived considerable satisfaction from their report, which gave credit for a reasonably good cost system where I, at least, thought credit was due.

When the lure of public accounting drew me to that field, I resolved to try not to forget the viewpoint of the man inside on the job and to try to gain his coöperation in carrying on my work. Except in a very few cases, that coöperation has always been given.

Peculiar and mysterious attributes, not to mention idiosyncrasies, have, by many people, been ascribed to public accountants, prior to the dissipation of the invisible barrier. One of my early assignments was to take temporary charge of the accounting department of a corporation then in process of reorganization. When the time came for me to withdraw from that office, one of the men who had at first kept himself aloof said to me, "You don't seem like the accountants I had heard about; you have acted quite like a human being."

Quite the opposite was my experience with the maiden cashier of another client, who took mortal offence when asked for the first time, which proved to be also the last time, to produce the petty-cash fund to be counted. To her mind her financial integrity could not and should not be questioned because of her record of thirty years without the loss of a cent. The client was appealed to in vain; he could find plenty of public accountants anxious for work, but not another maiden cashier with a perfect record of thirty years behind her—and the petty-cash fund was never counted.

In closing this rambling discourse I have a final question to put to your enterprising president. Perhaps he can tell me why, on the English form of balance-sheet statement, the assets are shown on the right and the liabilities on the left and why the American practice is the reverse. We have to admit that in England the profession of accountancy was established before it gained recognition in this country. But as we inherited many of our laws and customs from England, why did we change the assets from right to left and the liabilities from left to right on our balance-sheets? My conclusion is—the spirit of 1776.