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Progress in Corporate Financial Reporting

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This excellent paper was presented by Mr. Pitt at the Spring Conference of ASWA/AWSCPA held in Cleveland, Ohio, on May 26-28, 1950.

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He is a well known speaker before technical and civic groups on accounting and taxes.

PROGRESS IN CORPORATE FINANCIAL REPORTING

EDWARD L. PITT, CPA

As a topic of common interest, I have chosen to review with you some of the more important strides this growing profession of ours has made toward real improvement in financial reporting.

As a basis for this, we can turn to the work of the American Institute of Accountants' Committee on Accounting Procedure as published in their Accounting Research Bulletins. That Committee, consisting of twenty-one members, comprises a cross section of accountants throughout the country. Their pronouncements represent the considered opinion of at least two-thirds of the Committee. Except in cases in which formal adoption by the Institute's membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. Recommendations of the Committee are not intended to be retroactive. Its general rules may be subject to exception but it is felt that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment.

In its first bulletin released in September 1939, the Committee reissued the six rules adopted by the Institute's membership in 1934. I should like to summarize three of these rules which I consider especially pertinent:

Unrealized profit should not be credited to income account of the corporation either directly or indirectly through the medium of charging against such unrealized profits amounts which ordinarily would be charged against the income account.

Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which otherwise would be made against the income account.

Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent and its subsidiaries.

The Committee also reissued the opinion of the Committee on Cooperation with Stock Exchanges which, in brief, stated that:

The difference between the purchase price and the stated value of a corporation's stock should be reflected in capital surplus whether purchased for retirement or for resale.

Without attempting a complete resume of all thirty-nine bulletins issued to date, I should like to consider some of those which relate to the more common situations and, particularly, those which reflect a definite change in thinking.

The Committee has given extended consideration to the question of the proper accounting for depreciation on appreciation. The subject is discussed in Bulletin No. 5, issued in April 1940.

Accounting for fixed assets normally should be based on cost and any attempt to make property accounts in general reflect current values is both impracticable and inexpedient. Appreciation normally should not be reflected on the books of account of corporations. The Committee is of the opinion that when such appreciation has been entered in the books, income should be charged with depreciation computed on the new and higher values. This proposition is the most important part of the present statement and for it there seems to be general support. A corporation should not at the same time claim larger property values in its statement of assets and then provide for the amortization of only smaller property sums in its statement of income.

The conclusion does not rest upon any basis of narrow logic or precise classification. It is derived from considerations of equity and public policy of the broadest character. These include an application of something analogous to the legal doctrine of estoppel, which asserts that one who has made certain representations is thereby precluded from afterwards averring anything inconsistent with them. In its representations as to an increased value of plant, a company cannot afterwards account for depreciation and income as if it had never made such representations. When a company has made representations in its balance sheet as to an increased value of its property and others have bought its securities upon those representations, it is not unreasonable to interpret the formal adoption of the larger amount for plant as implying an intention on the part of the company to maintain that larger amount of invested capital intact by proper charges against income. To implement such intention it is necessary that the company charge income with depreciation on the larger values represented.

One of the areas of reversal of opinion started with Bulletin No. 13 dealing with special reserves arising out of the war. The bulletin was concerned primarily with the treatment of such reserves in the financial statements of organizations engaged in war production or those materially affected by conditions growing out of the war.

The Committee previously had recognized that it is desirable to provide by charges in the current income statement for all foreseeable costs and losses applicable against current revenues, to the extent that they can be measured and allocated to fiscal periods with reasonable approximation.

The Committee stated further that where reserves are created for possible war costs and losses the amounts of which are not presently determinable, provisions for such amounts should be shown in the income statement as deductions from the income computed on the usual basis. The purpose of the reserves should be displayed clearly. When the costs and losses of this nature are later determined they should be brought into the income statement in such a way as not to obscure the results for the period then current.

Where such reserves are relatively large it may be undesirable to use the term "net" income in relation to any figure in the income statement of either the period in which the reserves are created or the period in which the losses are ascertained and brought into account. They suggested the following procedures:

In the period in which the reserve is created:

Prepare the income statement to show the balance of income remaining after providing for all reasonably determinable costs and losses.

Deduct from such balance, provisions for the aforementioned possible war costs and losses, the amounts of which are not presently determinable.

State the remainder as the amount of income transferred to earned surplus.

In the period in which the costs and losses are determined and brought into the account:

Show as separate charges those items related to prior periods for which provision was made previously.

Show as a separate credit, a transfer from the reserves previously created for such purposes.

State the remainder as the amount of income transferred to earned surplus.

Thus we developed an income statement in which no amount appeared as net income. To some, this appeared as a serious weakness in financial reporting. However, the Committee had a most difficult job facing it and probably produced a satisfactory treatment for financial statements which we all recognized as being only tentative because of the extremely abnormal conditions. My principal complaint is that the bulletin opened the door for abuses in creating reserves out of income which, in many cases, probably should have been

simple appropriations of surplus. Concern has been expressed that some of the reserves were in fact designed for the purpose of equalizing income or were just pure contingency reserves.

It was not until the year 1947 that the air was cleared and the integrity of financial statements in this respect was restored. While the Committee did not specifically refute Bulletin No. 13, it did release Bulletin No. 28 relating to general contingency reserves set up by management which are not required at the time under generally accepted accounting principles and whose purposes are not specific.

The purpose of Bulletin No. 28 is to establish criteria which will promote sound accounting procedures for the treatment of general contingency reserves and lead to greater uniformity in reporting net income. Accordingly, the Committee stated that reserves for general undetermined contingencies, or for a wide variety of indefinite possible future losses, or without any specific purpose reasonably related to the operations for the current period, or in amounts not determined on the basis of any reasonable estimates of costs or losses, are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income.

The Committee recommended further that provisions for such reserves should not be included as charges in determining net income. When such a reserve is set up it should be created preferably by a segregation or appropriation of surplus but, and please note this, it may be created by an appropriation of net income although this is less desirable. If such a reserve is created by an appropriation of net income, the net income should first be determined and so designated, after which the reserve provision should be deducted and clearly captioned as an appropriation of net income and the final figure should be so captioned as to clearly indicate that it is not the entire net income. Costs or losses should not be treated as charges to such reserves and no part of such reserves should be transferred to income or in any way used to affect the determination of net income for any year. When such a reserve or any part thereof is no longer considered necessary it should be restored to surplus, either directly, the preferable treatment, or after the determination of net income in the income statement in such a way as to indicate clearly that it is not income.

Here at least we have a clear statement regarding the exclusion of contingency reserves from net income but the door has been left open tentatively to the appropriation of net income for such purposes. However, this has been rectified in a later bulletin, but before taking it up I should like to introduce Bulletin No. 31 dated October 1947. It deals specifically with inventory reserves such as those created for:

> Possible future losses on inventories not on hand or contracted for, or without regard to any specific loss reasonably related to the operations of the current period, or for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles.

The Committee takes the position that charges or credits relating to such reserves should not enter into the determination of net income and that they should not be used to relieve the income account of any year. If this type reserve is set up, it should be created preferably by a segregation or appropriation of surplus, no costs or losses should be charged to it, no part of it should be transferred to income, and the reserve should be restored to surplus when no longer required. The Committee recognizes as less desirable the alternative procedure of setting up the reserve by an appropriation of net income.

One year later, in Bulletin No. 35, referring to its previous pronouncements in recognizing this alternative treatment, the Committee believes the possibility of misconception in this respect will be minimized by its elimination. Accordingly, it is recommended that the net income for the period be shown henceforth without deductions or additions of items which are properly excluded from the determination of net income. These items consist primarily of charges and credits with respect to general purpose contingency reserves, inventory reserves, extraordinary items which if included would impair the significance of net income, and excessive costs of fixed assets.

Bulletin No. 14 issued in January 1942 is a startling reversal of opinion in that it condones the principle of offsetting assets against liabilities in the balance sheet. Where U. S. treasury tax notes were purchased with the intent that they be used for the payment of federal income and excess profits taxes, it is good accounting practice that they be shown as a deduction from the accrued liability for such taxes in the current liability section of the balance sheet. The full amount of the accrued liability should be shown with a deduction for the amount of the notes to be applied

in payment. The justification for this unusual procedure arises from the intent in the purchase of the tax notes which in substance represents a prepayment of the tax.

In December 1944, Bulletin No. 23 covered various problems in the reporting of income taxes in financial statements. The problems arise largely where material items entering into the computation of taxable income are not reflected in the income statement, and those items included in the income statement but not in the computation of taxable income. The basis for the newly developed theories is in the Committee's opening statement that "Income taxes are an expense which should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated." To illustrate one portion of this, let us assume a loss of $800,000 on the condemnation of real estate, which has been charged to surplus with an attendant reduction of $300,000 in income taxes. Under these circumstances, the Committee says that the reduction in taxes should be applied against the charge to surplus. Consequently the item would appear in the surplus statement as a loss from the condemnation of real estate, $800,000, less applicable reduction in income taxes, $300,000, or a net charge to surplus of $500,000.

Correspondingly, the Committee states that the amount of tax reduction should be included as a charge in the income statement either as an increase in the tax provision or as a separate charge for the portion of the loss equal to the amount of tax reduction. Thus assuming the tax payable to be $700,000, the income statement may disclose a provision for income tax of $1,000,000 with an appropriate explanation that the tax payable of $700,000 has been increased by reason of a reduction of $300,000 in taxes resulting from the loss on real estate charged to surplus less the related tax reduction. The second method of presentation would be to show the provision for income taxes, $700,000, and a separate charge for the portion of loss on real estate equal to the tax reduction applicable, $300,000.

In Bulletin No. 30, promulgated in August 1947, the Committee has redefined current assets and current liabilities. In the past, definitions of current assets had tended to be overly concerned with immediate or forced liquidation values. The tendency in recent years has been for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations and less upon the ability to pay in case of liquidation. The bulletin represents a departure from any narrow definition or strict one year interpretation of either current assets or current liabilities; the objective is to relate the criteria developed to the operating cycle of a business.

The Committee further states, for accounting purposes, the term current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

Specifically excluded from the current asset group are such assets as cash and claims to cash which are restricted as to withdrawal or use for other than current operations, or designated for expenditure in the acquisition or construction of noncurrent assets, or segregated for payment of long term debt; also excluded are investments in securities whether marketable or not which have been made for purposes of control, affiliation, or other continuing business advantage; and cash surrender value of life insurance.

The term current liabilities is used principally to identify and designate debts or obligations, the liquidation or payment of which is reasonably expected to require the use of existing resources properly classifiable as current assets or the creation of other current liabilities. The principal effect of this bulletin is the crystalization of opinion regarding classification of accounts as current or non current, recognizing for this purpose the operating cycle in some cases rather than the usual one year period; bringing into current assets certain prepaid expenses and specifically excluding such assets as cash surrender value of life insurance policies and other cash items not intended for use as current operating assets.

One of the more troublesome spots in financial reporting has been in the distinction between those items includible in the income statement and those includible in the statement of earned surplus.

In December 1947 the Committee directed attention in Bulletin No. 32 to the fact that the term income is used to describe a general concept, not a specific and precise thing. The income statement is based on the concept of the going concern. Profits are not fundamentally the results of operations during any short period of time. Allocations as between years affecting the determination of net income are, in part, estimated and conventional and based

on assumptions. While the items of which this is true are few in number, they sometimes are large in amounts.

It must also be recognized that there has been no ultimate distinction made between operating income and charges and non-operating gains and losses. The former are generally defined as recurrent features of business operation, more or less normal in their incidence from year to year. The latter are generally considered to be irregular and unpredictable, more or less fortuitous and incidental.

There have been two schools of thought as to what constitutes the most practically useful concept of income for the year. There are the proponents of the "all inclusive" type of income statement who would include both operating and non-operating items. They insist that annual income statements taken for the life of an enterprise when added together should reflect the total net income. They emphasize the dangers of possible manipulation of annual earnings by the omission of material, extraordinary items in the determination of income. They argue that when judgment is allowed to enter the picture with respect to the inclusion or exclusion of special items, material differences in the treatment of borderline cases will develop.

On the other hand, the proponents of the current operating performance type of statement place their principal emphasis upon the relationship of items to the operations, and to the year, excluding any material extraordinary items which are not so related or which if included would impair the significance of net income so that misleading inferences might be drawn therefrom. They consider it self evident that management and the independent auditors are in a stronger position than outsiders to determine whether there are unusual and extraordinary items which may give rise to misleading inferences with respect to current operating performance.

There are many good arguments on both sides and both sides agree in asserting that there should be full disclosure of all materials charges or credits of an unusual character including those attributable to prior years.

The Committee had previously indicated that, in its opinion, it is desirable that over the years all profits and losses be reflected in net income, but at the same time has recognized that under appropriate circumstances, it is proper to exclude certain material charges and credits from the determination of net income of a single year. In harmony with this view they have expressed the opinion that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus only extraordinary items such as the following may be excluded:

(a) Material charges or credits specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;

(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;

(d) The write off of a material amount of intangibles, such as the complete elimination of goodwill or a trademark;

(e) The write off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement of refunding of the debt maturity.

You might well say that we are right back where we started in this respect. However, I think some progress has been made in defining the character of the exclusions and placing emphasis on material significance of the items.

One of the most controversial issues in accounting and financial circles is the subject of depreciation on plant facilties in amounts in excess or depreciation based on cost to provide for their replacement at higher prices, and depreciating the portion of the cost of currently acquired facilities in excess of an estimated reasonable cost. This is the subject of Bulletin No. 33 released in December 1947 and I should like to summarize the Committee's conclusions in recognizing the problems.

When there are gross discrepancies between the cost and current values of pro-

ductive facilities, 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. (This was countermanded by Bulletin 35.) 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. The Committee disapproves immediate write-downs of plant costs by charges against current income in amounts believed to represent excessive or abnormal costs by current price levels. Attention is called 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.

Just one personal observation on this subject of depreciation. It seems to me that much confusion in thinking about capital assets and their depreciation can be avoided if we consider them in simple terms. Plant facilities represent merely a long term prepaid expense and their writeoff should be determined with that in mind. The period, or production benefited, should be charged with their prorata share of the related benefits. It is that simple in theory.

In November 1948, Bulletin No. 36 presented a distinct change in the accounting for annuity costs based on past services from that in common usage by many accountants. When costs incurred under pension plans are based in part on services performed prior to the adoption of the plan, the problem arises whether that portion of the costs attributable to such services is applicable to the past or to the present and future periods and, accordingly, whether that portion should be charged to income.

Charges with respect to pension costs based on past services have often been made against surplus on the grounds that such payments are indirectly compensation for services performed in the past. The Committee believes that even though the calculation is based on past services, the costs of such annuities are generally incurred in contemplation of present and future services, not necessarily of the individual affected but of the organization as a whole and therefore such costs should be charged to the present and future periods benefited. This belief is based on the assumption that although the benefits flowing from pension plans are intangible, they are nevertheless real. The element of past services is one of the important considerations of most pension plans and costs incurred on account of such services contribute to the benefits gained by the adoption of a plan. It is usually expected that such benefits will include better employee morale, the removal of superannuated employees from the payroll, and the attraction and retention of more desirable personnel, all of which should result in improved operations.

The Committee accordingly is of the opinion that the cost of annuities based on past services should be allocated to current and future periods and should not be charged to surplus.

Much consideration has been given to accounting terminology and a special committee has been working on it over a period of years. Some progress has been made although the evolution has been extremely slow. One of that committee's recommendations has been published in Bulletin No. 34, issued in October 1948, on the use of the term "reserve."

In past accounting practice the term "reserve" has been used in four general senses:

First, as an asset valuation deduction such as bad debt and depreciation reserves.

Second, as an estimate of liabilities of uncertain amount such as reserves for damages, disputed claims, and self insurance.

Third, to indicate a variety of charges in the income statement by means of which a reserve was created.

Fourth, to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose, as in the case of; A reserve for betterments or plant expansion; or a reserve for excess cost of replacement of property; or a reserve for possible future inventory losses; or a reserve for general contingencies; all of which are frequently referred to as appropriations of surplus or retained earnings.

Because the usage of the term "reserve" in the first three senses is contrary to the commonly accepted meaning of the term, the discontinuance of such usage is recommended.

It is further recommended that the use of the term "reserve" in accounting be limited to the last of the four senses mentioned, i. e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes.

Among the more popular changes in terminology has been the discontinuance of the use of the term "surplus." The recommendations of the committee on terminol-

ogy in this respect are contained in Bulletin No. 39 dated in October 1949. They recommend the use of the term "surplus" be discontinued, and that the term "earned surplus" be replaced by terms which will indicate source, such as retained income, retained earnings, accumulated earnings, or earnings retained for use in the business. Appropriations or segregations of retained income for general contingencies, possible future inventory losses, etc., should be included as a part of the stockholders' equity. Where there has been a quasireorganization, retained income thereafter should be dated. Where there has been a transfer from unrestricted to restricted capital by stock dividend or other resolution, the amount of retained income thereafter should indicate that it has been reduced and is the remainder after such transfer.

It is further recommended that the contributed portion of proprietary capital be designated as;

Capital contributed for or assigned to shares to the extent of the par or stated value of each class of shares outstanding, and

Capital contributed in excess of such par or stated value and capital received other than for shares.

While these recommendations were formalized in October 1949, they had been adopted by many corporations in their published reports long prior to that date and, together with other new terminology, have had very enthusiastic acceptance.

There have been many other changes in terminology and endless variations of the terms in use. There has been a concerted effort to make financial statements more understandable, particularly in their presentation to the public, and there have been some noteworthy accomplishments.

In bringing these random observations to you, I have attempted to show that the accounting profession is seriously trying to keep pace with our changing economic system; that it is diligently striving to obtain uniformity in accounting procedures and to produce financial statements which more clearly reflect financial results and financial position. While some of the pronouncements themselves may sound dogmatic, there has been no intention of finality in their publication. It has taken some courage to admit that some past principles were not the best and perhaps that some were not even proper. To me it is a healthy sign that we have come to a full realization that changing conditions require changes in thinking. It is an indication that the infant accounting profession is rapidly approaching maturity.

WHAT'S NEW IN READING

RUTH FORD, CPA, Columbus, Ohio

COMPANY ANNUAL REPORTS TO STOCKHOLDERS EMPLOYEES, AND THE PUBLIC. By Thomas H. Sanders (Copyrighted by The President and Fellows of Harvard College, 1949, and printed by The Andover Press, Ltd., 338 pages.)

This book points out the growing attention of the accounting profession toward corporate reporting, sponsored by the American Institute of Accountants and the Securities and Exchange Commission, as well as the profession at large.

The book contains excerpts from many letters from stockholders, corporate representatives, investment analysts, and labor union representatives expressing their criticism of corporate reports. The author outlines the steps being taken by many corporations toward meeting the divergent needs of these groups.

The book is practical and deals with all phases of the report: the trend toward presenting the balance sheet, income and surplus statements in a manner which can be understood by readers unfamiliar with accounting technique; the accountants' responsibility toward compliance with "generally accepted accounting principles"; the disclosure of pertinent facts in the notes to the financial statements; the presentation of charts, graphs, and pictures which are a part of many reports; the auditor's report and the report of the president to the stockholders.

It analyzes the recent trends in accounting practice which are engaging the attention of everyone in the accounting profession, from the student to the topmost accounting executive.

* * *

A man should choose a friend better than himself; if only like himself, he had better have none. There are plenty of acquaintances in the world, but very few real friends.

—*Chinese Proverb.*