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(Talk before Dominion Association of Chartered Accountants, Vancouver, B. C., September 10, 1947)

# RECENT ACCOUNTING DEVELOPMENTS IN THE UNITED STATES

By
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## Introduction

This is the first time it has been my privilege to attend a meeting of accountants in the Dominion of Canada, and I sincerely appreciate the opportunity. The problems of the independent public accountant are, in many respects, the same the world around, but because of the long, close, peaceful relationships between our two great countries, our many common business interests, and our use of the same language, our problems are undoubtedly more closely related and the importance of understanding each other's procedures greater than with respect to most other nations. I am complimented by the breadth of the subject assigned to me. It offers wide latitude yet obviously calls for the elimination of many matters that might be included. I shall try to report upon only a few of the more major questions that have recently been or currently are being given major attention by leaders in the profession in the United States. Regarding some of the matters still in the discussion stage, I shall venture to express some opinions--but please accept them as my own personal views for they are given without regard to the opinions of any of the members of our Institute's technical committees.

## The Committee on Accounting Procedure

Accounting developments in the United States during recent years have been closely related to the work of the American Institute of Accountants committee on accounting procedure. Its views have had a marked influence on the trends that have developed. The committee is made up of 21 members selected from large, small, and medium-sized firms of accountants located in large and small cities and in various sections of the country. It is customary to have on it two or three members who devote most of their time to university teaching in order to be sure the theoretical aspects of the committee's highly practical problems will not be overlooked.

The opinions of the committee are issued as a series of Accounting Research Bulletins. None are issued unless at least two-thirds of the members of the committee agree. Their authority rests upon the general acceptability of the opinions expressed in them unless formal adoption by the membership of the Institute should be asked and secured. To date, 30 bulletins have been issued and, although none have been presented to the membership for approval, those that have been out long enough to be judged have gained widespread acceptance and are recognized in authoritative quarters as expressions of generally accepted accounting procedures. The major purpose of the committee is to reduce the areas of difference in accounting procedures. During the year 1947 three bulletins, Nos. 28, 29, and 30, have been issued up to this time.

Contingency Reserves

In Bulletin No. 28 the committee unanimously and unequivocally took the position "that general contingency reserves, such as those created (a) for general undetermined contingencies, or (b) for a wide variety of indefinite possible future losses, or (c) without any specific purpose reasonably related to the operations for the current period, or (d) 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 has left for future consideration many aspects of reserves including inventory reserves, reserves for specific but undisclosed contingencies, and the general use of the term "reserve" in financial statements. These are now being studied by the committee.

Inventory Pricing

In Bulletin No. 29 on Inventory Pricing, the committee adhered to the "cost or market, whichever is lower" principle but it also restricted the extent to which there should be a departure from cost. Thus it said: "In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost." No preference was expressed for any one of the several assumptions as to the flow of cost factors such as "first-in first-out," "average," and "last-in first-out." Standard costs are recognized

only "if adjusted at reasonable intervals to reflect current conditions."

However, the position was taken that "a departure from the cost basis of pricing inventory is required when the usefulness of the goods is no longer as great as its cost" and stated that the measurement of losses from such sources is accomplished by applying the rule of pricing inventories at "cost or market, whichever is lower." In the application of this rule, though, the committee believed there should be greater restraint in writing-down than has been common practice. Its statement on this point reads as follows:

"As used in the phrase 'lower of cost or market,' the term 'market' means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin."

Thus a floor and a ceiling are placed on replacement cost in arriving at market.

This bulletin also took a clear cut position regarding the controversial problem of accounting for commitments. The statement on this point reads: "Accrued net losses on firm

purchase commitments of goods for inventory, measured in the same way as are inventory losses, should be recognized in the accounts. The amounts thereof should, if material, be separately disclosed in the income statement."

## Current Assets and Current Liabilities

In Bulletin No. 30, dealing with Current Assets and Current Liabilities, the committee took the position that past definitions of current assets have tended to be overly concerned with immediate or forced liquidation values. It took cognizance of the tendency in recent years for creditors to rely more upon the ability of debtors to pay their obligations out of the proceeds of current operations. Accordingly it defined current assets to mean cash and other assets or resources commonly identified as those which are reasonably to be expected to be realized in cash or sold or consumed during the normal operating cycle of the business. The term current liabilities is, in the same spirit, used principally by the committee to identify and designate debts or obligations, the liquidation or payment of which are reasonably expected to require the use of existing resources properly classified as current assets or the creation of other current liabilities. Thus, for example, cash designated for expenditure in the acquisition or construction of non-current assets or segregated for liquidation of long-term debt would be excluded from current assets as would the cash surrender value of life insurance policies.

## Current Unsettled Issues

At the present time the committee has before it a

number of important but highly controversial subjects. Some have not as yet been discussed at a committee meeting, but there is no doubt they will form the basis for extensive debate before substantial agreement will be reached.

Income and Surplus

The first and foremost relates to the nature of the income statement and is far from being a new problem. It has troubled the profession and business for a generation. The committee has struggled valiantly with it for over two years without reaching a satisfactory solution.

What constitutes the most practically useful concept of income for the year? On the one hand, net income is defined according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period except dividend distributions and capital transactions. The form of presentation which gives effect to this broad concept of net income has sometimes been designated the "all-inclusive" income statement. On the other hand, a different concept places its principal emphasis upon the relationship of items to the operations, and to the year, excluding from the determination of net income 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. This latter concept would require the income statement to be designated on what might be called a "current

operating performance" basis, because its chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the period covered by the statement.

Proponents of the "all-inclusive" type of income statement insist that annual income statements taken for the life of an enterprise should, when added together, represent total net income. They emphasize the dangers of possible manipulation of annual earnings if material extraordinary items may be omitted in the determination of income. They also assert that, over a period of years, charges resulting from extraordinary events tend to exceed the credits, and their omission has the effect of indicating a greater earning performance than the corporation actually has exhibited. They insist that an income statement including all income charges or credits arising during the year is simple to prepare, is easy to understand, and is not subject to variations under different conditions due to the judgments that may be applied in the treatment of individual items. 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 and that there is danger that the use of "distortion" as a criterion may be a means of rationalizing the normalization of earnings. With full disclosure of the nature of any special or extraordinary items, this group

believes the user of the financial statements can make his own additions or deductions more effectively than can the management or the independent accountant.

On the other hand, those who advocate the "current operating performance" type of income statement generally do so because they are mindful of the fact that a substantial number of the users of financial reports attach major significance to the income statement as an aid in reaching conclusions as to a company's future prospects. They point out that, while some users of financial reports are able to analyze a statement and eliminate from it those unusual and extraordinary items that tend to distort it for their purposes, many users are not trained to do so. Furthermore, they contend it is difficult at best to report in any financial statement sufficient data to afford a sound basis upon which the reader who does not have an intimate knowledge of the facts can make a well considered classification. 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, if included in the determination of net income, may give rise to misleading inferences with respect to current operating performance.

The advocates of the "current operating performance" type of statement join fully with the "all-inclusive" group in asserting that there should be full disclosure of all material charges or credits of an unusual character, including those

attributable to a prior year, but they insist that such disclosure should be made in such a manner as not to distort the figure which represents what the company was able to earn from its usual or typical business operations under the conditions existing during the year. They believe that material extraordinary charges or credits may often best be disclosed as direct adjustments of surplus. They point out that a charge or credit in a material amount representing an unusual item not likely to recur, if included in the computation of the company's annual net income, may be so distorting in its results as to lead to unsound judgments with respect to the current earning performance of the company.

No satisfactory compromise between these two schools of thought has been reached. A suggested form of presentation that seems to merit careful consideration would present in a single statement all items of profit or loss recognized during a fiscal period but certain material extraordinary items would be excluded from the determination of net income for the period but would be reported in a section immediately following the amount of net income and included in the determination of the amount carried to surplus. By this means the figure designated as net income would be determined on such a basis that it would have the greatest possible significance in helping to form a conclusion with respect to the earning performance of the business under the operating conditions existing during the year to which it relates while at the same time the presentation,

immediately following the figure of net income, of any material extraordinary charges and credits excluded from the determination of such net income, would enable users of the statements to appraise the significance of those items in relation to the results of operations for the year.

Minimum Disclosures

To a greater degree than ever before in our history, fair and full disclosure of information with respect to the financial affairs of business enterprise is important to persons outside their immediate management. The solution to a large proportion of the problems which face countries in which private enterprise is still predominant are tied up in the satisfactory settlement of the conflicting interests in business. Capital, management, labor, customers and the government, all have conflicting claims upon the proceeds of business operations. Labor is demanding that it be given financial information for its use in bargaining with management on wage contracts. The government in its taxing program, in the control of the securities markets, and in the regulation of public utilities, must have extensive financial data. The consuming public is becoming increasingly resentful of what appear to them to be exorbitant prices and is seeking the facts behind them. Stockholders and creditors far removed from management must base their decisions upon information they get from financial statements. These increased needs for fair, unbiased, adequate financial information places greater responsibility upon the public

accountant than he has ever had before. More than ever, therefore, he must satisfy himself through the exercise of sound technical procedures and informed judgments that the statements he certifies are not misleading either by misstatements they include or by the lack of information they fail to disclose.

By and large the profession has cause to be pleased with the manner in which it has fulfilled the requirements of this responsibility. We have constantly endeavored to evolve means by which users of financial statements may more readily determine the financial information they need, but as we are all aware, there is room for improvement.

One subject to which careful consideration is being given is whether the accountant should require a full set of financial statements (balance sheet, income statement, and analysis of surplus) to be included in all published annual reports to stockholders of which his certificate is a part. Accepted practice in this regard is in the process of evolution. It has not been many years since it was the universal practice to submit nothing but a balance sheet to stockholders, bankers, or other creditors. The income statement was considered to be purely supplemental. We all recognize that during the last quarter of a century there has been a distinct shift in the significance attached to the various statements. Today, a series of income statements is often considered of far more value than a balance sheet. This is particularly true of concerns that are so large that they are not likely to be

liquidated by the sale of individual assets and whose ability to pay is gauged more by an estimate of ability to earn than by the presence of assets upon which the creditor may pounce.

Somewhat similar to the practice of omitting basic financial statements in reports to stockholders is the practice of presenting statements that are highly condensed. This seems to be particularly prevalent in reporting income. In some rather extreme cases, companies furnish income statements which begin with a figure of "net income before depreciation and income taxes." It is even more common to omit information with respect to sales volume or the cost of sales. Generally the reason given for excluding such information from published financial statements is that the management believes it would be useful to competitors. In some cases this fear is probably justified, but consideration must be given to whether we are encouraging the presentation of these figures as often as we might. While in many cases it would be impracticable to break down this data to the extent necessary to give the reader of the financial statements a complete picture of the concern's operations, there can be no doubt but that trends in the total sales volume and in the gross profit which is derived from it are important in forecasting an enterprise's future accomplishments. It seems particularly unreasonable that such information should not be made readily available to the stockholders when it is, or before long will be, made a matter of public record with governmental regulatory bodies.

Complaints are also common with respect to failure to disclose the amount of reserves netted against assets, the use of omnibus reserves or reserves with ambiguous titles, reporting reserves for unspecified contingencies without further explanation or information with respect to charges and credits to them, the failure to disclose the basis upon which inventories are valued or to give information as to the proportions of raw material, work in process and finished goods, lack of disclosure of the method followed in determining cost of inventories such as last-in first-out, first-in first-out, or average stock, the basis of the valuation of fixed assets, and the number of shares of stock authorized issued and outstanding together with the par or stated value of the stock.

Reserves for Future Inventory Price Declines

During the past year, three very important and closely related problems have arisen. All spring from the fact that we have been in a period of rapidly rising prices and business anticipates the probability of a period of falling prices and depressed business conditions at some future date. The first is the practice of setting up, out of current income, reserves for future inventory price declines. Corporate executives have been greatly disturbed over the high costs and amounts of inventories they are required to carry. They admit that no one can foretell the future, but they believe it reasonable to assume that the present upswing in prices may be offset in whole or in part by price declines at some future date. Because

of the need to maintain adequate supplies of goods to meet every-day customer purchases and their belief that the losses which will have to be taken in periods of receding price levels have their origin in periods of rising prices, they are convinced of the desirability of reserving a part of current profits in anticipation of such losses. However, it is one thing to protect the balance sheet or surplus against the impact of possible future events but it is quite a different thing to charge that conservatism to income. Profits are determined by deducting from the revenues of a given period the applicable costs and losses. In the case of a mercantile or manufacturing business this consists primarily in matching revenue from the sale of goods with the costs of acquiring or producing them and of holding, selling or delivering them. To the extent that losses have already occurred in inventories as a consequence of fallen market prices, deterioration, obsolescence, or other relative causes which make it evident that costs cannot be realized by future sales, it is accepted practice to charge such losses off as being applicable to the period even though they are not related to the goods from which the current revenue is derived. This practice is justified on the grounds that the loss in market value has already been realized and is attributable to the period in which the loss takes place even though there are no revenues that have been derived from such goods against which the losses may be charged. When, however, reserves are set up to charge current costs with a loss which is expected to follow a period of unusually high prices, such as may exist

at present, no such relationship to the current period exists. Computations of reserves of this kind have to be made on the basis of assumptions as to what future price levels will be, what quantities will be on hand if and when the major price decline takes place, and, finally, whether loss to the business will be measured by the amount of the decline in prices. The bases for such assumptions are so uncertain that any conclusions drawn from them would generally seem to be speculative guesses rather than informed judgments. This affords strong support for those who contend that these reserves are based so much on whim that they should never be reflected in the accounts except as segregations of surplus.

Reserves should not be used to shift current profits to some future year because profits are currently high or to reflect opinions as to what constitutes normal profits. It is well recognized that the determination of income should be governed by accepted principles of accounting. Creation of a reserve by a charge to income is no exception. If there is reason for setting up a reserve through a charge to income under a particular set of circumstances when the management is favorable to its creation, the same reason would exist if the management were opposed. It seems clear that if reserves of this kind are to be accepted for accounting purposes, criteria should be established for their determination and they should be created in all cases where the circumstances are such as to indicate their need, and not created merely at the option of

the company, depending in part as to whether profits are high or low. In addition to affording a guide to management, criteria of this kind should also give the independent accountant a basis for objectively testing within reasonable limits the propriety of a reserve and the fairness of its amount. Because of the highly speculative and varied nature of the factors governing a decision in this field, however, the possibilities of developing such criteria seem very dim. Perhaps accounting needs may best be served by accepting the alternative and not attempting to create reserves of this kind through charges to income in any case.

## Depreciation on Replacement Values

The second of these new problems is the propriety of additional charges against income for depreciation in excess of that required on cost. This is the old question of depreciation on replacement value arising again because of an aggravated condition, claims against profits by union leaders, the social emphasis on the margin of profit, and perhaps because of other influences not so readily apparent. There are some very important companies which have publicized such additional charges against income, and the idea is sure to appeal to others.

Clearly, charges to income of this kind have no support in generally accepted accounting principles today. Depreciation is conceived of as an accounting method of allocating costs to fiscal periods, whereas provisions for replacement are considered to be problems of financial management rather than of accounting.

This is not to say that accounting principles as they now stand are sacred and should not be changed, but it must be recognized that this procedure is a violation of what are now generally accepted accounting principles and an exception to consistency. 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 cost of the replacement over the cost of existing assets should be accounted for as a cost of current production. Ignoring the accepted accounting practice of treating fixed assets as in the nature of deferred charges to be written off over their useful life and therefore requiring that depreciation be based on cost, it is important to emphasize the difficulties involved in an attempt to relate depreciation to replacement. 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. Very few facilities are replaced in exactly the same form. In many fields, processes and products are so changed that the same type of equipment is no longer the most suitable.

There is no gainsaying the fact that business management has a problem, but it may be questioned whether this problem is one that can or should be settled by changes in accounting procedures. Possibly what we are seeking is an adjustment of the concept of profits which would require the development of a monetary unit of constant value or the finding of some practical method of measuring our business activity in terms of index numbers. Accountants are in position to recognize the weakness of our present methods of computing profits in periods of violent changes in the value of the dollar and to help in reaching a sound solution, but it does not follow that the changes should necessarily be in accounting procedures.

## Reserves for Excess Construction Costs

The third and closely related problem arises out of the action on the part of several prominent companies of setting aside out of earnings a reserve for excessive construction costs in the year incurred, thereby reducing the income of the year of construction and reducing the amounts that will have to be

charged to future income in writing off construction costs. This has been upheld on the grounds that material costs and labor rates have increased very materially over prewar rates, and material shortages, unpredictability of materials deliveries, loss in productivity of labor, etc., have caused construction costs to be abnormal. Current high costs of facilities are a major concern to most persons interested in the financial health of a business. However, it is generally assumed that when a corporation undertakes the construction of a new plant it does so in the expectation that its future business will benefit from the investment; no other defensible reason comes readily to mind for doing so. It is a well recognized principle of accounting that the cost of an asset should be spread fairly over the fiscal periods during which its services are rendered. If, at the time the plant is constructed, inefficiencies, shortage of materials and labor practices run the cost higher than is believed to be normal, it must still be assumed that the company has weighed these costs and found them worth while for the benefit of the future. Otherwise, the construction could hardly be justified. It would seem to follow that if the plant is built it is expected to contribute its full worth to future revenues and that its cost should therefore be fully charged to the periods it will serve. Possibly the widespread adoption of straight-line depreciation has been responsible for some of the difficulties involved. Possibly depreciation policies should be developed under which companies constructing properties

at excessively high cost in the belief that the high profits of the earlier years would warrant the excessive cost would be able to assign a greater part of the cost to those earlier years. We, as accountants, have a responsibility to help solve this problem in a sound manner, but it seems clear that arbitrary reserves of this kind are not to be accepted merely because management feels that its current profits were too high and desires to charge off part of the current construction costs. If a procedure of writing off such excess costs is to be recognized in some cases it would seem that criteria should be developed for use in all similar cases.

Perhaps this recital has placed undue emphasis upon a few of our most significant recent problems. If so, I am afraid I must plead the fact that they stand high in my consciousness. We as public accountants have built our honored standing and high repute in our communities by helpfully meeting the problems of our clients with independence and objectivity. It is through meeting challenges such as those represented by the problems I have just discussed in a way that will inspire confidence in financial statements and make them more useful to those they are designed to serve that we fulfill our professional function in society, whether in your country or in ours. Perhaps the problems we have in the United States are no problems to you, but the basic responsibility of our profession, wherever it exists, is to judge soundly, act independently and view objectively whatever problems face it.