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CORRESPONDENCE

"Whose Balance-sheet Is It?"

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: When the editorial under the title "Whose Balance-sheet Is It?" in the December, 1939, JOURNAL appeared I was a critic. I disagreed, and here is the reason for my rash dissent. I thought the timing was inappropriate and that the membership had not been sufficiently prepared for the abrupt publicity. I believe now, however, that the discussion was beneficial to public accountancy, and that members should be encouraged to inform themselves about the subject. I followed the correspondence about it published in THE JOURNAL with interest. Mr. Lee evidently was seeking enlightenment and availed himself of the invitation of THE JOURNAL to the members to use its columns as a forum. I was surprised, therefore, to see an answer from one of the officers of the Institute published in THE JOURNAL which was more of a reprimand for making the inquiry than an informative reply. The Institute is supported by its members, and if it is to be a democratic organization it is the privilege of any member in good faith and clear conscience to question the pronouncement of any of the Institute's committees and to argue any accounting practice without fear of being belittled by someone who has by the Institute's members been elevated to a position of responsibility to our members. Such elevated members have no undefiable authority.

In any realistic discussion of a problem, we must explain all phases of the subject.

I am pleased that THE JOURNAL made it plain to corporate management that the public accountants are not going to let it escape its responsibilities and leave the public accountants "holding the bag."

An important point in the matter, I think, has been omitted in the discussion to which this publicity has been given. It is whether the printed annual reports to security holders, which contain the accountant's opinion, are in such form or so worded that the security holders are made fully aware of the primary responsibility of the corporate management as to the presented financial statements. I have analyzed many annual reports this spring and I think that they are not clear in this respect. It should be interesting if you would select at random one hundred reports for 1939, and ascertain how many of them contain the signatures of the responsible corporate officers appended to the financial statements or one word of verity from the corporation officials that the financial statements present fairly the condition and operating results. I found only two this year. I found, however, an English statement which contained the signature of two of the corporate directors as auditors in addition to the opinion of the chartered accountants.

An annual report for 1939 of a large listed corporation came to my attention the other day which had the name of the company on the cover, the opinion of a well known public accounting firm, the financial statements, and a list of the officers and directors. The cover contained the usual disclaimer clause about the purpose of the report and that it is not a representation in connection with any security sales, but there was no letter from a corporate officer, nor any signature of the corporate management subscribing to the verity of the representations in the financial statements, nor any statement to show whose "representation" it was—leaving one to a presumption, and to one who is not informed, not an accountant, and not fortunate enough to be a reader of THE JOURNAL, the presumption in this particular case could well be that the only person involved is the public accountant as his is the only signature in the whole document.

Further, how many audit reports of public accountants, in their binders, which reports are shown around, and auditors know that fact, contain a statement of verity of corporate management and officials subscribed to the accounts in the auditor's cover, to inform the reader about the dual responsibility?

I believe, therefore, while in full agreement with the principle of primary responsibility set forth by the committee, that we have stopped short of the necessary corporate representation and signatures.

I hope that the following quotation has no relation to our subject: "It is strange how you will do a job with more than ordinary care when you have a fault upon your conscience. It is almost as though you thought to make your industry a form of penitence." (*How Green Was My Valley*, by Richard Llewellyn, p. 33.)

Yours truly,

WILL-A. CLADER

New York, N. Y.

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I think I have a right to protest when a member of an Institute committee, through the columns of THE JOURNAL, attributes to me an assumption which I have never made and which is not a fair inference from anything I have ever said.

In his June communication, Mr. Stempf makes the following statement:

> "Mr. Lee assumes, rather naïvely, that when one says the audit begins with the balance-sheet, it also means that it ends there."

I have never assumed anything of the kind. The assumption is purely a figment of Mr. Stempf's own imagination, and the misconception which he characterizes as "too utterly fantastic" is entirely his own.

Yours truly,

EARLE GOODRICH LEE

St. Paul, Minn.

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I have read Mr. Lee's letter on page 386 of the May JOURNAL. Practically all of the participants in the forum, "Whose Balance-sheet Is It?" at the Institute meeting in San Francisco last fall wished to take the side that the balance-sheet was the client's. In order to make the session more provocative of discussion, Mr. Stempf urged that some of the members take the other side of the question.

Mr. McIntosh graciously agreed to do so in a spirit of coöperation in order that the round-table discussion might be of the greatest interest to all members, in spite of the fact that he felt differently on the subject. Credit is due to him for this.

At the close of the session those in attendance at the discussion were substantially all in agreement that the balance-sheet was the client's. The "Institute management" was not noted as being in attendance.

Yours truly,

EDWARD P. TREMPER, JR.

Seattle, Wash.

"The Relation of Depreciation Provisions to Replacement"

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: So much interest has been shown in my article which appeared in your May issue that I am tempted to supplement it with some further discussion which, in the interest of brevity, I omitted from that article.

I perhaps failed in it to make clear the fact that the over-all rate of depreciation on the entire plant would not be similar to that on the additions for a single year, but would be much more heavily weighted with longer lived property. Just what the relation between the two over-all rates would be cannot be determined from available statistical evidence. It may, however, be possible to get some indication of the maximum probable difference by making some assumptions.

Since the question arises in relation to the question that we have now reached a mature economy, we may consider what the depreciation rate would be if there had been a continuous annual investment, uniform in amount and composition, for a length of time exceeding the life of the most durable unit—practically fifty years, on the basis of Dr. Fabricant's tables. If we should also assume that retirements have occurred and will occur in accordance with his estimates, the position would be that there would be an investment in each class of property equal to the annual investment multiplied by the number of years of estimated life, and the annual depreciation charge would be equal to the annual investment. Using Dr. Fabricant's table we should find that the weighted average depreciation rate in such circumstances would be about 4.8 per cent, and a table constructed in the same manner as that appearing on page 345 of the May issue would be as shown in table at top of page 70.

It will be observed that the proportion of the investment represented by property with a life of over 20 years would be 63.6 per cent

Estimated life	Per cent of total investment	Per cent of annual depreciation	Average depreciation rates
10 years and under but over 3	8.6	26	14.1
20 " " " " " 10	27.8	36	6.2
Over 20	63.6	38	2.9
	100	100	4.8

as compared with 28 per cent shown in the table on page 345.

Dr. Fabricant in his table separates construction from other durable producers' goods. Making the calculations for the two classes of property we should find that 55 per cent of the whole investment would be in construction and 53.2 per cent in construction with a life of over 20 years.

Now, the positions in regard to reproduction costs and technological progress in relation to construction are very different from those in relation to other producers' goods. Undoubtedly a large part of our construction, such as hotels, apartment buildings, and offices, has proved obsolete much more quickly than was anticipated, and there is no reason to think that replacement with the types now required would be cheaper than the original construction. On this type of property depreciation, provisions are doubtless proving inadequate to secure either a return of investment or replacement. Typically, I suppose, large hotels, office buildings, and apartment-houses are owned by separate corporations and probably much of the loss on these properties never appears in the reports of income or profit and loss from which estimates of net corporate savings are computed.

The calculations which have been made, though dealing with hypothetical and quite unrealistic figures, suggest that the factor of technological progress may be far less important than was assumed by Dr. Altman and Dr. Hansen, and confirm my view that their conclusions were incorrect.

Since my article appeared, the Brookings Institution has published its volume, *Capital Expansion, Employment and Economic Stability*, and on page 23 thereof the suggestion is made that even under the income-tax law, allowances may exceed the actual depreciation. No evidence is given to support this suggestion, and any weight it might have is impaired by the fact that on page 171 it is said that the rate allowed on machinery under the law is 10 per cent.

The fact is, I believe, that the rate allowed on machinery varies from 4 per cent to 10 per cent, and that a comparatively small proportion is subject to the 10 per cent rate. An examination of the preliminary report of the Internal Revenue Bureau of January, 1931, shows a rate of 5 per cent for all but one of twelve classes of steel mill machinery, and out of some 60 classifications under the head, "Textile, Weaving and Knitting," only one item—sewing machines—is allowed as high a rate as 10 per cent.

A steel manufacturer has sent me a statement showing that in the last six years his company retired property of a book value exceeding $10 millions, and that existing reserves in respect of the property provided for only 60 per cent of the loss, leaving 40 per cent to be met by charges to income or profit and loss.

The American Iron and Steel Institute has also published figures of plant expenditures of companies representing 90 per cent of the industry. Total expenditures for the four years 1935–1938 are given as $794 millions—depreciation provisions during the same period as $489 millions—new capital issues other than for refunding, $483 millions. These figures are interesting in view of the testimony before the Temporary National Economic Committee of Mr. Stettinius and Mr. Sloan in regard to capital requirements of the industry.

Moreover, I have had occasion to compare the depreciation allowances on the English basis with ours on plants representing an original investment of over $100 millions. I was not surprised to find that the English allowances were the greater, notwithstanding that property is less freely scrapped in England than with us.

The idea that our depreciation allowances are excessive from either an economic or a tax standpoint is, I am convinced, ill founded.

Yours truly,

George O. May

New York, N. Y.

"Last-in, First-out"

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Professor Paton's paper "Last-in, First-out" represents a good presentation of the argument that the first-in, first-out basis of inventory pricing is the more proper. It appears, however, to overstate the case and to give inadequate recognition to certain features of the last-in, first-out method.

The basic issue here centers about the matching of cost and revenue in the most satisfactory manner. Professor Paton, writing in conjunction with Professor A. C. Littleton in *An Introduction to Corporate Accounting Standards*, has on page 69 called this the crucial phase of accounting and has pointed out that this periodic matching is "essentially a matter of judgment and interpretation." He has further stated on page 71 of this same monograph that "The problem of properly matching revenues and costs is primarily one of finding satisfactory bases of association—clues to relationships which unite revenue deductions and revenue. As suggested above, observable physical connections often afford a means of tracing and assigning. It should be emphasized, however, that the essential test is reasonableness in the light of all pertinent conditions, rather than physical measurement. Even in the handling of direct material charges, for example, it is often necessary to recognize that the problem of assignment *is a matter of economic rather than of physical flow*." [Italics mine.] These references clearly indicate that there is more than one basis of associating costs and revenue, and that judgment or reasonableness must be the criterion in the final analysis.

The first part of the article deals with the variation which develops between the application of the first-in, first-out method on a day-to-day basis and under the circumstances when all of the data for the month are available. The latter approach is the more convenient and practical and must be defended on that basis; the day-to-day approach is in accordance with the true theory of last-in, first-out because presumably the sales are also being made on the same day-to-day basis. The choice, however, must in some cases be a compromise between the ideal theory and practical necessities.

In the next section the effect of the last-in, first-out method is shown as it affects the reporting of periodic income. The argument here—that artificial stabilization attained through arbitrary tinkering is to be condemned—is really no argument at all unless one agrees that the last-in, first-out method is just that. One can just as well start out with the assumption that the best basis of associating cost and revenue is the last-in, first-out method and that therefore the use of the first-in, first-out method is itself the tinkering which is so undesirable.

Whether there is a recognition of unrealized profit because of higher cost inventories purchased in an advancing market again depends largely on one's original assumption as to which costs should logically and reasonably be matched with the revenue of the period.

The argument that the first-in, first-out method conforms more closely to the physical usage of the inventory items has a certain amount of merit, but it runs counter to the above statement that other more reasonable bases developed in the light of all pertinent conditions may overshadow the physical aspect.

The illustration of accounting for delivery trucks to disprove a resemblance between inventories and fixed assets is hardly conclusive. In any event, the compelling arguments for the use of the last-in, first-out method center in the income statement and not the balance-sheet. There seems to be no lack of agreement in our day with respect to the lesser importance of the balance-sheet and the greater importance of the reporting of income.

It is in connection with the income statement that the strongest case can be made for the last-in, first-out method. It is indeed a fortunate circumstance when the accountant can conform to cost as a standard—since last-in, first-out is one kind of cost just as clearly as first-in, first-out—and still make the income statement more in conformance with economic realities. It is maintained by the writer that the last-in, first-out method employs a matching procedure which is not only more reasonable but is in closer conformance with the thinking of the business community—hence more realistic and generally useful. Moreover, the effect of using the first-in, first-out method is to magnify profits during the upswing stage of the cycle and to exert the contrary influence in the downswing stage. If we really mean what we say about the accountant's responsibilities to the groups he serves it seems this should influence his choice of method—especially when both are within the boundaries of historical cost. To assume that it is only proper to match costs with revenue in the first-in, first-out sequence is to border on slavish adherence to a physical concept which even Professor Paton has himself denied. At least it would seem that the use of the last-in, first-out method is within the limits of acceptable standards.

Yours truly,

VICTOR Z. BRINK

Hanover, N. H.

"British and American Attitudes"

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Upon looking over your issue of June, 1940, I am moved to make a few unsolicited comments.

The first editorial arouses my local pride and jealousy. While the president and the secretary of the Institute were attending the Southern States Accountants Conference, the Illinois Society, in coöperation with a large assortment of educational, professional, and business groups, held an accounting clinic in Chicago on the subject of annual reports of corporations. These groups came in numbers to attend an all-day and evening meeting, and went away with some new insight into the nature of financial statements and accountants' reports. All this was done without benefit of the wise men of the East, but we could do with a small pat on the back. Hell hath no fury sharper than a serpent's thanks.

With the iron thus penetrating my soul I approached the second editorial, but found nothing on which to feed my captiousness. What this one lacked, however, the third one had in full measure. British and American attitudes are compared in this editorial by one who appears, from his acceptance of the British viewpoint, to be a confirmed Anglophile. There is quoted from *The Accountant* a paragraph which is about as smug a piece of writing as I have seen. The British tell us that everything is as it should be in that best of all possible islands. I profoundly doubt it. A much fairer comparison of British and American attitudes would be to say that the British refuse to peer into their cesspool, maintaining that all must be good and true because it should be; we turn the strong light of day into ours.

There is, however, another aspect of this matter which it is foolhardy to ignore. Comparison of the United States with other nations should always recognize that we are a less homogeneous people than most of them. The diversification of our population as to background and social and group consciousness, makes American life rich and fascinating, but it carries with it certain dangers. I am proud that I live in a country which has earned the title of "melting pot," but I have no wish to deny the consequences. One of these is in the measurable field of crime, and I have been authoritatively informed that crime in the United States is more prevalent than in most countries with which we would expect to be compared. The same mind that will conceive and execute crimes, will conceive and execute frauds, and the same social environment which fosters one will foster the other. Although I do not accept the British argument that frauds do not exist in England, merely because they refuse to dig them up, I am prepared to believe that we may have more of them, and therefore more need for machinery to control them. This does not mean that integrity in America is any weaker or on any lower level than that in other countries. I am inclined to think that the reverse is true. Certainly we have our full share of starry-eyed idealists. But it does mean that the proportion of our people who deviate greatly from the normal may be greater than in the more homogeneously settled British Isles.

At any rate, the record, even during the last decade, after business professed to have learned its lesson, is sprinkled liberally enough with financial frauds, to justify doing something about it. Instead of the conclusions reached in the editorial, I suggest either that there are more British frauds than their lax methods have uncovered, or that we have more than they do, or both.

Yours truly,

EDWARD B. WILCOX

Chicago, Ill.