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Some Issues in Accounting

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THOSE OF YOU from Akron University and Kent State who are "commencing" in June, are graduating into a profession that is alive and aggressive. One of the surest signs of professional vigor is the willingness to debate the profession's issues in the spotlight of public attention. By this test both 1962 and 1963 have shown a good deal of professional vitality. We have debated, there is no question. Perhaps now we need to reconcile by searching for the central issue.

ACCOUNTING ISSUES

I am confident that the specific issues, debated ever so vigorously, concerning postulates, broad principles, tax allocation, price-level adjustments, the investment credit, and other matters, spring from a common source. They are tied together with a common thread spun by the effort to establish definitely the relationship and trend between items and events and having opposing forces tugging at each end. These forces divide on the question of how to achieve financial-statement comparability.

A number of accountants probably would argue that most accounting issues would disappear if there were a consensus on the postulates and broad principles. This I doubt very much. I look with favor on the quest for the postulates and the broad principles and on the efforts to codify them. They will be helpful in narrowing some of the differences in accounting practices. But in my view, agreement on the postulates and principles will not and should not eliminate all of the differences.

COMPARABILITY AND UNIFORMITY

Accountants have a common goal in establishing accounting practices. They strive for comparability in financial statements. I know not one accountant who rejects this as an object of accounting. But I find accountants at various points of the scale in their estimate of the desirability of financial-statement uniformity. Let me make this point clear: Uniformity and comparability are two different things.

Comparability means that differences as well as similarities are brought out. It furnishes a basis for choices and for weighing them. Uniformity, on the other hand, means that things are made to look alike and that differences are made to disappear. Accordingly, too much uniformity may destroy comparability. Too little may make comparisons difficult because similarities are obscured. So the real issue in accounting today relates to uniformity: How much of it is too much? How little of it is too little?

It is quite natural, I suppose, that those reading financial statements on behalf of the investing public would press for more uniformity in financial statements. Uniformity makes easier the mechanical process of comparing things. The danger, of course, is that the comparisons become simply algebraic and possibly misleading. Paradoxically, if carried too far, uniformity destroys the very thing that it seeks to achieve.

INTERPERIOD COMPARABILITY

General

One aspect of uniformity relates to comparisons between periods. Here the comparison is not between companies but rather between financial statements for different intervals of time. I do not propose to revive old issues in this regard. There have been many over the years. One had to do with the question of what items should be taken directly to retained earnings, that is, the issue of the all-inclusive income statement versus the current operating performance notion. Here the tugging forces were concerned with the desirability of eliminating from the income statement those items which are extraordinary or non-recurring, but which by their nature, perhaps belong in income. Practice today recognizes parts of both positions.

Another interperiod issue related to the matter of reversing charges previously made, such as those for depreciation.

Direct Costing

Direct costing as an issue concerns comparability between periods. The direct costers argue in substance that certain costs, particularly the fixed or sunk costs, are assignable to periods rather than to products. They argue that the measure of net income between periods should not be affected by the variation in the amount of fixed costs assigned to inventories because of differences in the level of

production. They argue that income varies with sales, and should not be made to appear to vary with production.

Investment Credit

The issue of interperiod uniformity seems in part to have brought about the investment-credit controversy. Let's use it to illustrate the nature of the varying positions on interperiod comparability.

On the one hand there is the view, expressed by the majority of the members of the Accounting Principles Board in its Opinion No. 2, that the investment credit provided for by the 1962 Internal Revenue Act is a factor in determining the cost of the related property. Two supporting arguments are offered: (1) income arises from the use and not the acquisition of property, and (2) ultimate realization of the credit is contingent on future developments. The substantive argument here seems to be the one of relating income to the use instead of to the purchase of property. The argument about the uncertainty of realization seems not pertinent in considering the nature of the investment credit.

The majority opinion seems to be that the income of period 2 should not be greater than the income of period 1 if the only difference between periods 1 and 2 is that a new tax law in period 2 made it possible to reduce the tax liability through purchases of property. In other words, the majority apparently felt that the two years, as to income, should be made to look alike—that a lower tax liability stemming from property additions was not enough to make the years different.

The other view says, in effect, that the years were not alike. It says that the income of a period is determined by applying the principles relating to revenue measurement and realization and the matching of costs with revenue. It says that the investment credit serves to reduce tax expense by the amount of the credit and that the reduction in taxes is realized by reason of the existence of taxable income. It says further that since a portion of the credit likely will be offset by higher taxes in the future (because of lower depreciation deductions), consideration will have to be given to the need for a charge to income equivalent to the amount of higher taxes payable in the future.

The arguments for each side seem plausible. Each argument appears to rest on a principle that has been applied before to other situations. Why then is there such a controversy? I think that one

of the reasons is to be found in varying attitudes toward the degree of interperiod uniformity considered desirable in the basic structure of the financial statements. One view leans in the direction of not letting an event affect income unless the earning power of a company or the level of operations has been changed by it. The other leans toward letting the event affect income if the usual tests of realization and revenue-expense matching are met. Each would call for disclosure of the effect of the event, if material.

Insistence on complete uniformity as between periods would freeze the prevailing accounting practices of a company. This would not make sense, of course. Disclosure and the consistency words in the auditor's report have been the means through which comparability between periods is achieved when accounting practices have been changed. On the other hand, even with disclosures and mention in the auditor's opinion, frequent jumping about from one generally accepted accounting practice to another ordinarily is undesirable, because it tends to make comparisons more difficult and to obscure differences.

INTERCOMPANY UNIFORMITY

Then there is the aspect of uniformity relating to comparability of companies, and the issue becomes one of how uniform their financial statements should be to permit valid comparison. The number of specific issues grows when we consider intercompany uniformity.

Price-Level Adjustments

Consider the issue of price-level adjustments in financial statements. Companies have acquired their assets and incurred their debts at different times and in different markets. Their financial statements accordingly reflect varying price levels. Their income statements include different kinds of dollars and, accordingly, their net income figures may reflect widely varying mixtures of price levels. This leads many accountants to the conclusion that financial statements should be adjusted to a common-size dollar, in the interest of intercompany comparability.

Own-Lease

Some companies own the properties used in their business, others rent them. Some rent them under arrangements providing for

possession and use in much the same way as is afforded under outright ownership. Again uniformity is the issue. Is comparability best obtained by bringing properties and related liabilities into the balance sheet in both cases? Or is it best obtained by letting balance sheets show the differences between renting and owning, and using separate disclosure to bring out pertinent information? As an aside, it is interesting to note there seems to be no one urging that companies owning their properties should be preparing financial statements as if they rented the properties.

Income Tax Allocation

The income-tax allocation controversy manifests both the intercompany and the interperiod uniformity issues, perhaps more of the latter than the former, but some of both. In its extreme form, tax-effect accounting would provide for taxes at the going rate, say 52 per cent, and let the other part of the entry flow through a balance-sheet account, which presumably would have one principal purpose —to make the balance sheet balance. Such a procedure presumably would be in the interest of making all periods and all tax-paying corporations alike in tax expense. The other extreme would be to do no tax-effect accounting. The tax provision would relate to the returns for a year. Most accountants today would say that neither extreme is desirable. The whole issue, accordingly, is one of finding a position in between. Some would place it rather close to the 52-per-cent-effect position, others would place it closer to the non-tax-effect position.

Investment Credit

The investment credit controversy stems in part also from different attitudes concerning intercompany uniformity. Some look at the matter from the standpoint of two companies in the same business with the same level of operations and the same selling prices and cost prices but a different incidence among years of property acquisitions; and they conclude that the two companies should not show a different amount of net income in any given year simply because of a different amount of investment credit. Others hold that a difference in the amount of investment credit is a substantive difference, that there is solid income when and to the extent that taxes have been permanently reduced.

INTERINDUSTRY UNIFORMITY

Applicability of Principles

A third type of uniformity concerns companies or organizations operating either in different industries or with different purposes. Here the basic issue is whether the same postulates and principles apply to industrial concerns, regulated companies, non-profit organizations, and others. There is, I think, no issue concerning basic matters such as continuity of the entity, cost and revenue and the matching of them, adequacy of disclosure, and the like. The issues relate, instead, to uniformity of application of principles and the extent to which, for example, regulatory aspects affect the application of principles.

Profit and Non-Profit Entities

Uniformity issues also arise in considering financial statements of profit-seeking businesses and non-profit institutions or organizations. This issue, too, calls for separate study. I leave it with one observation. We should think long and hard about effecting uniformity in financial statements serving significantly different purposes. I am inclined to think that comparability between financial statements having significantly different purposes is largely a myth. If they are made to look alike, they may no longer serve their separate purposes. This could be uniformity at its worst.

RESULTS OF UNIFORMITY

Uniformity Stretches Concepts

One result of uniformity of financial statements is a straining of basic accounting concepts. For example, to account for leased property as if it were owned requires some extention of the usual idea of an asset and of a liability. Tax-effect accounting requires considerable stretching of the usual notions of liabilities, assets, and even of the revenue-expense matching principle. Is a deferred debit for a tax difference a good asset? Is income-tax expense, that is, an income-determined figure, matchable with revenue in the same way as an income-determining item?

Again, if the investment credit is by its nature a cost-reduction factor, what is the rationale of starting the accounting for the cost of property at a figure lower than its bargained price or its current

cost? What is the logic of saying that the cost of property is affected by whether the business has income and by the service life of the property? Too, the usual concept of realization is stretched when it is denied that a permanent tax reduction is income of the period when the reduction took place.

Price-level adjusted financial statements reflect stretched, if not entirely different, concepts of income and capital. Whereas capital conventionally has been dollar capital, in price-level adjusted financial statements it is purchasing-power capital. Whereas income conventionally has been a measure of the number of dollars that could be distributed to the owners of a business without impairing dollar capital, in price-level adjusted statements it is the number of dollars that can be distributed without impairing purchasing-power capital.

Results in "As-If" Accounting

One phenomenon of the uniformity issue is an effort to square "as-if" accounting with "as-is" or "as-has-been" practices—that is, to argue that conventional practices call for as-if accounting. For example, there has been much rationalizing concerning income tax expense in connection with tax-effect accounting. It is argued that it is like other expenses, that it should be allocated like other expenses, and so on, when as a matter of fact it is not like other expenses in its relation to revenue, since it derives from income. Similarly, it is argued that price-level adjustments are like foreign-exchange translations and that they are necessary to reflect true historical cost. It has been argued that the investment credit is like purchase discount and, accordingly, a cost reduction. It is argued that possession of leased property is like ownership and that the rental obligation is like the debt relating to purchase. Analogy accounting often provides the argument supporting greater uniformity.

Analogy accounting is desirable, in my opinion, when the analogy springs from the same basic principle, but is superficial and ordinarily leads to contradiction when applied to isolated conditions or facts.

Differences are Made to Disappear

Another manifestation of the uniformity issue is an apparent tendency to place in limbo, or to make disappear completely, certain differences, as to both substance and major form, between transactions or financial arrangements. Generally, when the substance is

the same the accounting should be the same. There are situations in accounting, however, when this guide cannot be followed, because the subjectivity that must be introduced reflects on the general credibility of the financial statements. An example may be found in the recommendation that the portion of a leasing transaction tantamount to ownership should be recognized as property and a liability. Unless some standards of credibility can be established for selecting a rate to use in discounting the future rental payments, comparability may be impaired rather than enhanced by showing a liability in the balance sheet.

There is the question, too, of how far accounting should stretch the legal fabric of transactions to make them look alike. No matter how much like a purchase a leasing arrangement may be, there are choices available to the owner of property for its use that are not freely and independently available to a lessee. Should financial statements make them look alike?

Emphasis on Earnings Per Share

Perhaps it is helpful to search for the reasons why accountants and others hold to such different positions on the matter of uniformity and seem on certain issues almost to reach an impasse. One reason, I suppose, concerns the emphasis placed on the figure of earnings per share. No single figure, or single series of a given figure, can be made to portray adequately the financial affairs of a company; there is no disagreement about that. One view accepts it as a fact that earnings per share is given almost exclusive attention by the investing public and, accordingly, would gear accounting to making the earnings figure representative of earning power. The other view would attempt, instead, through education, to change and extend the public understanding of the meaning and limitations of financial statements, and would place great emphasis on disclosure while the education continues.

It is interesting to speculate on whether tax-effect accounting would be an issue today, at least to the degree that it is an issue, if income statements had rather consistently shown earnings per share before income taxes as well as after, and if the provision for income taxes generally had been shown as a separate last-item deduction in income statements. I think it is reasonable to conclude that there would not have been much tax allocation if the public had learned to deal inseparably with before- and after-tax earnings figures.

Management Attitudes Are Different

The thing that gives me the greatest concern about too much uniformity is the fact that financial-statement users will infer that things are alike when they are not. It seems natural to me that the attitude of a company's management will and should be reflected in the financial statements. One management will push ahead with an investment or with expansion when another will hold back. One will abandon research efforts before another. One will favor a particular form of financing over another. One will seek diversification, another will concentrate its efforts. One will adopt certain practices in employee compensation, others will try something else. These differences bear directly on the future benefits of incurred costs and the service lives of assets. They also bear directly on the extent to which a company can be expected to protect itself against market risks, obsolescence, supersession of its products, and all other business risks.

These differences are pertinent to accounting measurements and, accordingly, accounting determinations should not make a constant out of them. To do so will mislead, because not all pertinent facts and conditions are brought into the comparison.

Too much flexibility is not the answer either. We should constantly strive for a narrowing of differences in practice that weaken comparability. At the same time we should keep in mind that what appears to be a difference in accounting practices is not a difference at all if it reflects the way in which companies through their managements react to business developments. Management attitudes and expectations, which prompt actions affecting the financial affairs of a company, are different. Accounting that equates them is incomplete, and in some situations may be misleading.

I see no reason, for example, why any particular method of depreciation, such as the straight-line method, should be imposed on all businesses. The results would be uniform but not realistic or comparable. Straight-line may be right for one and wrong for another, because of variations in management expectations which get translated into actions. Different depreciation methods may be appropriate even when all physical factors are alike, including the assets under consideration and the products made with them, for the reason that the managements of companies react in entirely different ways to market developments and to changes in general economic conditions in making property additions and replacements.

CRITERIA FOR SUITABILITY

To the end of minimizing accounting differences, I am about persuaded that the way to make progress is to establish criteria supporting the use of or creating a presumption in favor of a particular accounting method or procedure. For example, I think it much more fruitful to search out the conditions calling for straight-line depreciation and those calling for a decreasing-charge method than it is to conduct a study to find out which of the two methods should be followed by business generally. Perhaps we should be sharpening up the criteria to be applied, for example, in determining which inventory costing method, that is, Lifo, Fifo, and the rest, should be used in a particular set of conditions.

The former committee on accounting procedure of the AICPA did some work of this kind. An example that comes to mind is the committee's bulletin on business combinations which distinguished between the conditions supporting a presumption that there was a pooling of interests on the one hand and a purchase on the other. All in all, however, not a great deal has been done in the way of describing conditions that would seem to support a preference for a particular practice. It will be helpful if the special studies being made under the general supervision of the AICPA Accounting Principles Board will consider this aspect of the problem.

Postulates and principles provide a common fabric from which the patterns for financial statements are cut; a common fabric ordinarily leads to comparability. But postulates and principles do not fix the pattern of the financial statements for a particular company in a particular industry. Companies act and react like persons because persons make them act and react. The financial statements reflecting them will be comparable if they fit; that is, if they bring out their shapes, sizes, and personalities. But they must fit.