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Harold W. Scott

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Current Accounting Trends in Corporate Reporting of Financial Information

By Harold W. Scott
Partner, Detroit Office

Presented before Birmingham Chapter of the National Association of Accountants—March 1960

I envision the subject assigned to me by John L. Rhoads, your program director of a year ago, as encompassing a reporting task, which in itself should avoid all areas of controversy. I know, however, that you will forgive me if from time to time in my remarks I stray to a slight degree from my rôle as "reporter" and perhaps express a shading of opinion that might be deemed to be prejudicial on certain of the subjects discussed. It is somewhat difficult to talk authoritatively on "current" trends in corporate reporting so early in the year because when this paper was prepared we had not had an opportunity of reviewing many of the crop of calendar year 1959 reports, which are blossoming in profusion right at this time. However, based on the few latest reports seen, developments in accounting thinking over the past few years, and the prior year reports available, one can arrive at certain conclusions regarding the most recent trends in the reporting of accounting information. Incidentally, it is assumed that we are concerned with reports by corporations to their stockholders and outsiders and the accounting principles that influence the financial statements included in such reports, and not with the multitudinous reports prepared internally for the information and guidance of management.

As a practicing public accountant, I hope you will forgive me for first referring to the American Institute of Certified Public Accountants as background for future references to "generally accepted accounting principles." As most of you know, for many years the AICPA has had a Committee on Accounting Procedure, composed of prominent members of the accounting profession who have served the Committee with distinction for varying periods of time. Since 1938 the American Institute has issued 51 Accounting Research Bulletins formally stating certain principles of accounting that, in the opinion of the Committee, had authority with the accounting profession and the business public concerned with such matters because of their general acceptability. Many of us from time to time have disagreed with some of the conclusions of the Committee, as have individual members thereof, but over the years it has rendered a valuable service to

the profession and has attained stature with the business community and with governmental agencies concerned with accounting matters, such as the Securities and Exchange Commission. As most of you also know, the existence of the Committee on Accounting Procedure was terminated during the year 1959 and its last bulletin, on Consolidated Financial Statements, was issued in August. The Committee has been succeeded by an Accounting Principles Board, which, with the aid of a director of accounting research and his staff, will in the future have the authority in the Institute to make or authorize public pronouncements on accounting principles. It is the expressed hope that pronouncements by the new Board will narrow some of the areas of difference and inconsistencies in practice among various business enterprises.

The general aim of narrowing differences and inconsistencies in the application of accounting principles is, of course, desirable and a goal toward which we should strive. I for one, however, deplore the efforts of some to reach a point where we would be completely straightjacketed through the adoption of rigid rules of practice, either through governmentally enforced edicts or universal espousal by the profession, if such espousal were forced on some by a vocal group before a practice is in fact "generally accepted." This goal has, of course, been practically reached by some of our regulated industries, such as the railroads, with the result that accounting has stagnated to a degree that progress has virtually stopped. As we know, with respect to the railroads, many of the account classifications have not been changed since the adoption of the uniform system of accounts by order of the Interstate Commerce Commission many years ago.

Accounting, as the language of business, is, and must be, a moving, vital force changing with conditions. It would be abhorrent to think of reaching a point where free-thinking men could not have differences of opinion as to the application of alternatively acceptable principles. Yet I, as well as you, have heard numerous speakers decry these differences in application. Just a short time ago I heard a financial analyst express the opinion, on a N.A.A. program, that all corporations should be compelled to draft their financial statements in a uniform manner so that each company within an industry, and even from industry to industry, could be compared item for item and each item would be determined in exactly the same manner and would mean exactly the same thing.

A well-known member of the public accounting profession has

for several years promoted the establishment of a so-called "accounting court" which would have authority to issue and enforce decisions on accounting principles and the application thereof. It was rather astounding to me to hear this practitioner espouse, on the same platform from which he asked for enforcement of practices by court procedures, the sole use of the LIFO method of inventory costing and the computation of depreciation on replacement valuations of property. His attitude indicated he believed that the court should enforce these procedures, apparently to the exclusion of all others in these areas. I believe that there are many members of the accounting profession and accountants in industry who would disagree with the practices sponsored by the practitioner in question and would vigorously oppose enforcement by an "accounting court."

I realize that difficulties are encountered in intelligently comparing financial statements of corporations today and, as I previously stated, we should continue our efforts to iron out differences. However, our "ironing out" process should be carefully handled in a manner consistent with our established concept of freedom of thought, and progress must be made through educational processes. A principle should not be described as generally accepted by edict unless it has in fact been "generally accepted" by the profession and the business community.

An example of two alternatively acceptable practices might be cited with respect to two corporations in my own state at the end of the calendar year 1958. During the year 1958 the State Legislature passed an act changing the assessment date for real and personal property from January 1 to December 31, effective December 31, 1958. For corporations deducting property taxes for federal income tax purposes on an assessment-date basis this afforded an opportunity of deducting property taxes for two years in their returns for the calendar year 1958. It also posed the problem of whether the liability for the second round of taxes should be accrued on the books as of December 31, 1958 and, if accrued, where the offsetting charge should go. If charged to income, the income for the year as reported would be doubly burdened (less the federal income tax effect). If not accrued and charged to income on the books, income would be benefited by the savings in income taxes if the provision for the latter taxes were made on the books on the basis of taxable income determined by taking a double deduction from taxable income. In the case of Burroughs Corporation, the additional liability for property taxes of approxi-

mately $3,100,000 (apparently determined after reduction for the savings in income taxes) was charged to "expenses paid in advance" and the amount was carried in the balance sheet as a deferred charge at December 31, 1958. In the case of The Detroit Edison Company, of the total additional tax of $22,000,000 an amount of $11,440,000, representing the reduction in federal income taxes, was charged to income and the remainder of $10,560,000 was charged to surplus. Thus, both Burroughs and Edison recognized the liability and there was no effect on net income in either case. However, Burroughs made no reduction in its surplus, whereas Edison reduced its surplus in the balance sheet by $10,560,000. Which of these treatments could be singled out as following a generally acceptable principle or practice? Arguments could be advanced pro and con for either. Incidentally, the financial statements of both of these companies were examined by the Detroit office of the same national accounting firm, and no mention of the matter was made in the opinion in either case. It would appear that the accounting firm considered that both treatments were alternatively acceptable because the liability was accrued and there was no distortion of income in either case.

It is of interest to note in passing that under the Technical Amendments Act of 1960 the Treasury Department is proposing to have Congress enact an amendment that will make it impossible to deduct two-years' property taxes from income in one year merely by changing the assessment date.

There has developed over the past few years a greater realization that the financial statements and other factual information in reports are the representations of the company and not of its public accountants. The function of the latter is the expression of an opinion, based on audit, that such statements present fairly the financial position and results of operations in conformity with generally accepted accounting principles. Thus, in the Burroughs and Edison situations described above the managements obviously had different ideas about the most desirable treatment and the accounting firm believed it proper to accept both in rendering its opinions. The Securities and Exchange Commission has exerted an important influence in obtaining acceptance of the idea that financial statements are the direct responsibility of management. No longer can management avoid this responsibility by referring to the certifying accountants as being solely responsible for the presentation.

There undoubtedly has been a healthy trend during the past

several years toward presenting financial information in a more readable and interesting manner. The financial statements of themselves have in many instances been simplified and drafted to insure easy reading. In addition, most reports of today contain summaries of financial information so that the reader can find pertinent information highlighted in capsule form in tables early in the text portion of the report. This information should be as accurate as that shown by the financial statements, but as there is more latitude in the form of presentation, it is easier to pique the interest of the reader. While detail financial statements are essential and are necessary for readers informed in such matters, such as financial analysts, credit grantors, et cetera, it must be acknowledged that the average stockholder finds the reading of financial statements a boring task to be avoided if possible. For that reason the presentation of summarized information in reports to stockholders is highly desirable. It naturally also is desirable that the information be presented in comparative form for two or more years. There surely is a movement toward the presentation of summarized financial information, as shown by the 600 reports analyzed by the American Institute of Certified Public Accountants for 1958 as compared with a similar analysis made for 1950.

In addition, many reports contain supplemental schedules of one form or another. One of the most informative of such schedules, which is appearing in more reports each year, is a statement of changes in working capital and of the source and application of funds. In addition to the financial statements, usually presented in comparative form for the current and the preceding year, most reports today also contain schedules of balance sheet and operating information for five, ten, or twenty years. This information is, of course, helpful in showing the growth and progress of a company over the years.

The degree of detail observed in notes to financial statements in comparing published reports to stockholders is of interest and in some cases probably indicates differences in attitudes of the individuals concerned with the presentation of financial statements. Of the 600 reports analyzed by the Institute for 1958, notes were included by 570 companies, whereas the reports for 30 companies, including some very large companies, contained no notes. If notes were deemed a necessity by 570 companies properly to explain the financial statements, one wonders why the managements of 30 companies deemed them to be unnecessary. Furthermore, the extent of the notes in those reports containing notes varied from one or two sentences or para-

graphs to many pages. While it would appear that notes are usually required, some of the notes presented are so long and technical that the stockholder either refuses to read entirely or he becomes lost in a maze if willing and able to pursue the text to the last period. Education to the end of having some uniformity in the conception of what should be contained in notes is badly needed so that all pertinent information will be presented in concise, readable language and extraneous material will be omitted.

There are at present a few areas where controversy has continued over the past several months among those interested in accounting and the presentation of financial information in reports. I would like to take this opportunity to discuss some of these areas briefly.

CURRENT-VALUE DEPRECIATION

The agitation for permitting the computation of the allowance for depreciation on the basis of the replacement value of property, or for permitting some equivalent allowance, has continued unabated. The proponents, many of whom are prominent people and very vocal, point to the declining value of the dollar and to the fact that in the income statement we are matching current sales dollars with dollars of depreciation based on dollars of years past. For this reason it is their contention that net income as presently being reported is overstated and unrealistic. The opponents to the theory, who are not so vocal but I would assume much more numerous, decry the efforts to depart from the historical cost concept of depreciation accounting and are apt to question the sincerity of some of the proponents because of developments to date in view of the non-deductibility of the additional depreciation for income tax purposes. They argue that depreciation is a measurement of the expiration of expended dollars for plant and equipment and is not for the purpose of accumulating funds for replacement or expansion of facilities, which accumulation should be the responsibility of an informed management through proper dividend and other policies and not of the accountant. They also emphasize that of the new dollars spent on plant property, undoubtedly the major portion is for the improvement and expansion of facilities or for the acquisition of new facilities and is not for mere replacement.

Many of us remember the golden days of the twenties, when it was the fashion to write up fixed assets through the appraisal method in order to fatten balance sheets for merger and other purposes. In those days the accounting profession had to fight long and vigorously

to convince the optimistic management instrumental in recording the appraised values that the provision for depreciation on the write-up in values should be charged to income and not to "appraisal surplus." It was a case of "have your cake" through inflated asset values and "eat it too" by not charging income with the write-off of these values. Then came the depression of the thirties and it became commonplace to write off plant assets by charges to surplus—in some cases against capital through quasi-reorganizations—in an effort to bolster income through lower depreciation charges in the future. Since then we generally have stayed with historical costs, which at least have a solid accounting foundation and are not subject to varying interpretations by the use of economic and other factors. The late Marquis Eaton, former president of the AICPA, once questioned "whether changes in accounting principles can compensate for the imperfection of money as a common denominator without sacrificing other vital purposes of financial reporting. Abandonment of the keystone of adherence to the cost principle may well carry in its wake sacrifices of other vital purposes of financial reports."

As you undoubtedly know, the American Institute has conducted two surveys on the question of depreciation on replacement values versus historical costs. The problem assuredly is not a new one, as shown by the fact that an article on the subject appeared in a N.A.C.A. bulletin in 1923. The sincerity of the advocates is challenged from the standpoint of "pure theory" when it is recognized that some of the zealots among the business people surveyed lost much of their zeal in answering the question of whether they would favor a change if the additional allowance were not deductible for tax purposes. Furthermore, both the American Institute and the American Accounting Association have advocated the inclusion in financial reports of supplemental statements showing the effect of price-level changes. The business public has failed to take advantage of this opportunity to make such a presentation. In the September 1959 issue of *The Journal of Accountancy* a news feature stated that only four instances were noted in 1958 reports where supplemental statements were presented to show "price-level" depreciation, and three of the four companies were public utilities. One wonders where the advocates of the theory were when the reports were prepared.

From the foregoing it is apparent that there is little evidence of price-level depreciation information in the reports published to date, despite the recommendations of two outstanding accounting associa-

tions to have such information presented in supplemental statements that would be of interest to report readers.

An interesting side light was the contrasting attitudes of management and labor during the recent steel strike on the question of steel company profits. Management took the position that profits were overstated because depreciation was computed on historical costs and effect was not given to the decline that had taken place in the purchasing power of the dollar through price-level adjustments. Labor, however, contended that all that should be recovered through depreciation was original cost and that anything in excess of that was a profit. Furthermore, labor argued that profits actually were understated because depreciation usually was computed under the provisions of the Internal Revenue Code which permitted accelerated depreciation, under the declining-balance or sum-of-the-years' digits methods, whereas it was contended that the original cost should be spread evenly over the expected period of use of the plant. For the latter reason, labor's position was that depreciation for the years since January 1, 1954 (the effective date for the accelerated methods) was excessive and reported profits were unrealistically low.

Some of the proponents of the price-level theory point to the LIFO basis of inventory valuation as being comparable. The comparison does not seem to be valid because LIFO at least is based on an incurred cost of some time, whereas price-level depreciation would be based upon estimates computed on the basis of economic indices and other factors.

DEFERRED INCOME TAXES

With the revision of Accounting Research Bulletin No. 44 in July 1958 on Declining Balance Depreciation, the number of reports showing Deferred Income Taxes, or an equivalent thereof, increased considerably in 1958 and 1959. As you know, under the original bulletin issued in October 1954 the Committee expressed the opinion that in situations in which the declining-balance, or other accelerated method, was adopted for tax purposes but other appropriate methods were followed for financial accounting purposes, it would not ordinarily be necessary to recognize deferred income taxes in the accounts except under a few cited unusual conditions. In the revised bulletin, issued almost four years later, the Committee took the position that when the amounts of the difference between tax and book depreciation are material, recognition should be given to deferred

income taxes, except for the rare cases of certain utilities where charges for deferred taxes are not allowed for rate-making purposes. In the bulletin the Committee stated that while provision for the period subsequent to the date of issuance should be based on all assets acquired after 1953 for which the declining-balance or other accelerated method had been elected for tax purposes, it was not mandatory to make a retroactive adjustment for prior periods, although it was permissible to do so if desired. While certain corporations that provided for deferred taxes in 1958 and 1959 for the first time because of the issuance of the bulletin adjusted for prior years, others did not. For example, in the 1958 report of Swift & Company it was noted that the reduction of taxes because of accelerated depreciation amounted to $1,600,000 and $2,775,000 for the fiscal years ended in 1958 and 1957, respectively. However, the only provision made in the accounts at the end of the 1958 fiscal year was for $447,597, representing the computed amount for the period subsequent to August 1, 1958 (the bulletin was issued in July 1958). In the report of Swift for the year ended October 31, 1959 deferred income taxes were provided for in the amount of $1,876,115, resulting in a total deferral of $2,323,712 in the balance sheet at October 31, 1959, representing the 1959 provision and the provision of $447,597 for the period from August 1, 1958 to November 1, 1958. On the assumption that the provision would have averaged approximately $2,000,000 annually for the years 1954, 1955, and 1956 (a fair assumption inasmuch as the computed amount for 1957 was $2,775,000) and had provision been made in each year since 1954, the accumulated amount in the balance sheet at October 31, 1959 would have been $12,251,115 (instead of $2,323,712 as shown), computed as follows:

1954, 1955, and 1956	$ 6,000,000
1957	2,775,000
1958	1,600,000
1959	1,876,115
Total	$12,251,115

Based on the calculation above, the deferred tax liability account on the balance sheet was understated by about $10,000,000. If the theory of accruing for deferred taxes, presumably to be paid in the future, is a proper and necessary accounting principle, one naturally questions why retroactive adjustment should not be required, with the full liability reflected in the balance sheet.

Bulletin 44 of the Committee recognized that as an alternative

procedure it would be appropriate, instead of crediting a deferred tax account, to recognize the difference in taxes based on book and tax depreciation as additional amortization or depreciation applicable to the assets. In reviewing reports issued for 1958 and 1959 it is interesting to note that practices have varied greatly among the various companies. Some have charged income as taxes and credited a deferred tax liability account. Some have charged income as taxes but have credited an accumulated depreciation account. Others have charged depreciation expense and have credited accumulated depreciation. In the Swift report mentioned above, in 1958 the credit of $447,597 was made to accumulated depreciation but the charge was made to the income tax provision. In the 1959 report the balance sheet amount for 1958 was reclassified in the 1958 column as "deferred taxes" and the provision for 1959 was charged and credited as deferred taxes. A somewhat similar reclassification appeared in the June 30, 1959 report of The Procter & Gamble Company. In the 1958 report the tax reduction was charged to depreciation expense and credited to accumulated depreciation. In the 1959 report the additional provision was charged to taxes and the credit was made to a deferred tax account. The 1958 figures were reclassified in the 1959 report for comparison with the current year.

These varied methods of providing for deferred taxes again demonstrate the difficulty of setting rigid rules in the application of accounting principles. Probably after a few years a practice will develop that will be "generally accepted," but in the meantime there appear to be several acceptable alternative practices.

In the report of First National Stores for the year ended March 28, 1959 appears a note to the financial statements indicating that the company has a policy regarding depreciation on store buildings under which depreciation is computed on a basis that is related to the estimated fair rental value of the buildings. This depreciation is in addition to allowable income tax depreciation computed under the straight-line and sum-of-the-years' digits methods. The report of Sears, Roebuck and Co. also indicates that it uses an accelerated method in providing depreciation on certain equipment which results in depreciation in the accounts in excess of that allowable for income tax purposes. While these instances are the reverse of those requiring deferred tax accounting, there is no indication in the reports concerning whether adjustment for income taxes was made in the financial statements.

DIRECT COSTING

The direct-costing theory has received continuing attention during the past year, particularly by our association through its conferences, seminars, and literature. As a management device for internal purposes in industry it is, in my opinion, an excellent tool for the assignment and measurement of responsibility. However, as I have so many times told Ray Marple, one of the staunchest advocates, once having accepted the theory for management purposes, the proponents seem to go through a brain washing which induces them to promote its use for inventory valuation and external reporting purposes. However, despite the promotional efforts of some, I have seen little evidence of the use of direct costing in published reports. With respect to inventory valuation, it is difficult for an orthodox accountant to believe that an article carried in inventory which yesterday was produced by a labor force of 200 men at a certain cost was reduced overnight to a fraction of its previous cost because 175 of the 200 men were replaced through the investment of millions of dollars in an automatic machine. Carried to the logical conclusion of complete automation, inventory valuations of the future would be restricted generally to the cost of material and direct supplies only, despite the fact that the greatest portion of the actual product cost rests in the amortization of the cost of the expensive machinery necessary to produce. While not an accountant, the elder Henry Ford in his lifetime had a better understanding of the function of machinery than do some of the more rabid of the direct-cost advocates when he described a machine as nothing more than "stored up direct labor" available for use when needed. If this description is at all apt, a portion of the cost of the machine resides in each article produced by it.

LEASES

During the past several years there has been a growing tendency on the part of business enterprises to lease more and more of their capital facilities. In many instances this has resulted in the elimination from the assets in the balance sheet of major amounts of plant and equipment and also from the liabilities of debt incurred to acquire such facilities. As a result, fixed charges for depreciation and interest have been replaced by rents. Problems of reporting have been created by these changes, which are crying for attention if financial statements are to be fully informative. Rents under leases usually are hidden in

the operating accounts, although they are as fixed as the charges that they replaced, which usually were shown or could easily be determined from the financial statements. In an article in *The Journal of Accountancy* a year ago Mr. Phillip L. West, Vice President of the New York Stock Exchange, advocated showing rentals under leases as a separate item in the income statement. In most instances where rentals under leases are important today, there is a growing tendency to show the amount of the aggregate annual rentals in the notes to the financial statements. It was of interest to note that in an article in the December 1959 *N.A.A. Bulletin* Mr. Kenneth R. Rickey, Vice President and Treasurer of Lenkurt Electric Co., Inc., stated that in its report as of December 31, 1958 his company achieved a "first" by reflecting in its balance sheet all of its leased facilities and related long-term lease obligations at the discounted amount of the long-term lease obligations. One wonders if this treatment as a "first" gives any indication of possible future practice. In any event, the item is important and a solution to the problem is needed.

CONSOLIDATED STATEMENTS

As previously stated, the last Accounting Research Bulletin was issued in August 1959 by the Committee on Accounting Procedure on the subject of Consolidated Financial Statements. This bulletin described the purpose of consolidated financial statements and attempted to set forth guides to be followed in determining the subsidiaries that should be consolidated with the parent in the presentation of consolidated statements. The bulletin pointed out that in deciding on consolidation policy, the aim should be to make the financial presentation that is the most meaningful in the circumstances. While general standards were described to attain this goal, it is found in reviewing consolidated financial statements that much more education will be required to attain any sort of uniformity in practice within the standards set forth. Even in situations where conditions seem similar, consolidated financial statement policies in actual practice seem to range all over, from no consolidation to a complete consolidation. Thus we find one set of statements in which all subsidiaries, both partly owned and wholly owned, and foreign and domestic are consolidated. We find other instances where no consolidation is made at all or at least only wholly owned domestic subsidiaries are consolidated. In other cases the consolidation may be expanded to cover all domestic

subsidiaries, whether partly owned or wholly owned, or all wholly owned subsidiaries, whether foreign or domestic. This seems to be an area where more uniformity in practice should be the goal of the accounting profession and the business community concerned with financial statements.

The question of 50%-owned companies also cries for attention. In many instances important investments are represented by a 50 per cent ownership in an associated company, with the other 50 per cent owned by another single entity. It has been the generally accepted practice to carry these investments in the balance sheet at cost and not to reflect the company's equity in earnings, except as dividends are paid. Financial statements on this basis may not be too meaningful when the equity in these companies has increased significantly since acquisition and the earnings are material in relation to the earnings of the company holding the investment. One company, Monsanto Chemical Company, feels so strongly on this matter that it presents two sets of financial statements in its published report. One set, to which the opinion of the independent public accountants applies, is prepared in the conventional form and follows what is now deemed to be the generally accepted practice. The other set reflects the company's proportionate share of the assets, liabilities, sales, operating accounts, and net earnings of the 50%-owned companies. Monsanto believes that conventional accounting practices are not proper in the case at issue.

One of the interesting provisions of the bulletin on consolidated statements relates to cases where the cost to the parent company of an acquired company is less than its equity in the net assets of the purchased subsidiary as shown by its books. It is stated that, under usual circumstances, the amount at which the net assets of the subsidiary are carried in the consolidated statements should not exceed the parent's cost. While a procedure sometimes followed in the past was to credit capital surplus with the amount of the excess of the book equity over cost, such a procedure is not now considered acceptable.

While on the subject of the acquisition of subsidiaries and other types of mergers and combinations, the matter of whether a transaction is an "acquisition" or a "pooling of interests" under Bulletin No. 48 of the AICPA has received considerable attention in financial statements of the past few years. The "pooling of interests" theory apparently has had a popular appeal, and an obvious effort seemingly has been made to follow that theory in all cases where it is at all possible under the rather general criteria set forth in the bulletin.

From the foregoing discussion, it would seem that accounting principles and practices are far removed from the point where rigid rules can be enforced. As previously indicated, a long educational and evolutionary process seems necessary before general acceptance can be attained, and even then it appears that there always will be areas where two or more alternative procedures may be deemed to be "acceptable." We also always will be confronted with new problems that must be solved, and a sound solution only can be found by the applied thought of many minds and perhaps by the proven method of trial and error.