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Accounting principles and the investment credit: An Interview with John W. Queenan

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ACCOUNTING PRINCIPLES AND THE INVESTMENT CREDIT

In 1962 Congress enacted the investment tax credit to stimulate industry's investment in capital assets. The Accounting Principles Board, in its Opinion No. 2, first decided that the credit, for accounting purposes, should be spread over the life of the related property rather than being all taken into income the year the property was purchased. A year and a half later Opinion No. 4 was issued, stating that this spreading or "deferral" method was still the preferred method, but that the current income or so-called "flow-through" method was also acceptable. Then, in September 1967, the Board published the exposure draft of an Opinion on accounting for income taxes, the investment credit portion of which called for reversion to the deferral-only position. However, in December the Board set aside that portion for further study, leaving the alternatives still open.

Your editors have felt that it might be useful to query Mr. Queenan about this somewhat perplexing sequence of events, and at the same time to gain further insight about how accounting thought develops.

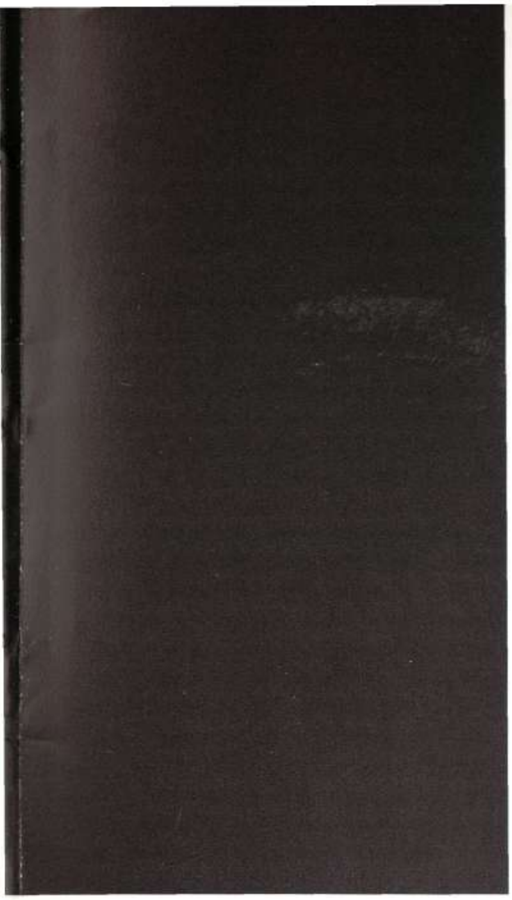
Interviewer: Mr. Queenan, throughout the more than five years since the investment credit was enacted, when Mr. Powell was on the APB and then you, Haskins & Sells has been an energetic leader of the minority group on the Board that said "flow-through" is the proper accounting method. Would you say this action by the Board in setting aside the deferral-only proposal is a victory for our H&S position?

Mr. Queenan: No, I don't think I would. The majority of the Board still favors deferral. On the other hand most of the thousand corporation executives and practitioners, and many of the educators, who wrote to the Board about the matter favor flow-through. So the question is still entirely undecided.

But I don't like the connotation of the word "victory." I don't think you should picture this as two opposing groups battling to a decision. That is not how accounting thought moves forward, at least not in my judgment.

How did the Firm come to adopt its position?

We spent a great deal of time analyzing all of its aspects. In the beginning, the law required that the credit be deducted from the cost of the property for figuring depreciation, so with the corporation tax rate at 52 per cent, a



AN INTERVIEW WITH JOHN W. QUEENAN

little over half of the credit eventually went back to the government. We agreed this half should be deferred, but not the other half which the company kept free and clear—without necessity to take further action or to incur additional cost.

We looked at this other half as it fitted into the existing framework of accounting concepts. We saw it quite simply as a reduction in income tax expense. This, to us, was an indisputable business fact. And as a matter of fact, most of those favoring deferral now agree. They used to view it essentially as a reduction in cost of the property, but now they only say it is *related* to the property and its use.

Why did they change?

I don't know that the reasons are clear-cut. The fact that the tax law was changed in 1964 to provide that the credit was not to reduce the basis of the property probably had something to do with it. In our view, of course, that change made the entire amount of the investment credit a reduction of tax expense, not just half of it.

Now, under present accounting concepts, revenue, or a reduction in expense, is recognized—that is, picked up in income—when no further action need be taken or further cost incurred in realizing it—when the company has an unconditional right to it. The investment credit is realized as soon as there are current revenues that give rise to the tax expense that the investment credit reduces. So there is no reason, within the accounting framework, to defer it.

Then how do the proponents of the deferral method support their position?

Well now, I don't know that it's fair to them for me to be explaining their position. However, I can express my difficulty with it. They seem to depend heavily on something they say is an accepted concept: that income results from the use of property, not from its acquisition. With this idea in mind, they say that the investment credit—which they thus classify as income—is primarily associated with the property acquired, and that it should therefore be allocated to the periods in which the property is used.

That seems like a rather plausible position to take.

Oh, it does have an appeal, and it did particularly when the argument was that the credit was a reduction in the cost of the property. But when you examine it, it just doesn't hold water. First, I think the idea that "use rather than acquisition of property produces income" is a generalization or an observation relating to revenue recognition, rather than expense reduction. Second, the idea that the credit is associated with the property is not pertinent, in our view. Many factors are associated with the use of assets—the amount of maintenance costs, for example—but nobody has suggested that such costs be charged to income in proportion to depreciation charges.

Third, it is quite a strained view to look on the credit as "income" from the government. But even if it were "income," then it seems inescapable that it would have to be considered as earned when there had been compliance with the statutory provisions. Except for the remote possibility that there might be a significant amount of recapture, compliance with the statutory provisions, in most cases, is immediate. So the reason for deferral would not exist.

These are technical objections. But something that more deeply concerns me is the philosophy behind this deferral position. I can only see in it a belief that the tax reductions that arise from the investment credit should be leveled, that there is something inherently wrong in the bunching of the credit that can occur when capital asset purchases are higher in some years than in others. I find this philosophy in a number of places in the argument made for deferral. For instance, one stated objection to flow-through is that it may result in increasing or decreasing net income solely by reason of the timing of acquisitions. Another is that management may time their acquisitions — and thus their credits — as a matter of business policy. Also it is feared that the recent increase in the allowable amount of the credit will even increase these fluctuations.

To me, this philosophy is absolutely wrong. What the effects may be on net income or on the pattern of earnings does not furnish the starting point for determining the accounting for a business fact. It is the other way round: you account for business facts by their natures and net income is the result of the accounting for all of its components.

May I go back for a moment? When it was evident in 1962 that the majority of the Board wanted "deferral," why did we persist in our position?

If you mean after Opinion No. 2 was issued why didn't we recognize the deferral method as the only generally accepted practice as the Opinion required, that was because it quickly became overwhelmingly evident to us that the flow-through method also was widely accepted. The diversity of views that had existed before the Opinion was issued persisted, and the SEC said it would accept flow-through.

It was not our belief that there *should* be alternative methods. But Weldon Powell, who was Board chairman at the time, could see no consensus among the members, and there was no basis in experience for general acceptance of either method alone. So he favored going through an aging process that might show us which one method would gain general acceptance.

Now, if your question means why didn't we remove our dissent from the Opinion before it was published, then I would say that to remove it would be to undermine the whole structure. The recording of dissent if it exists gives credibility to the positions taken. After all, if you believe your position is logical and practicable, and no one has been able to show you where you're wrong, you can't just give in for the sake of outward unanimity. When the Board is split as widely as it was—and is—on the investment credit, then it must consider whether the matter it's working on is really ready for a definitive answer.

It seems to me that being logical is a matter of being reasonable, too, and it might have been reasonable and logical back in 1962 just to have accepted the investment credit as a property cost reduction. After all, the main thing is whether people understand it or not, and that treatment seems eminently understandable, even if it doesn't fit into the accounting framework. A red traffic light means stop, but if we changed it to blue and everyone agreed that meant stop, what's the difference?

Well, as a matter of fact that's right, so long as you make the stop lights blue everywhere. But what would more likely happen is that you'd have blue meaning stop at one intersection, but then there would be some special reason for having orange at the next intersection, somebody else would want yellow at the next, and so on. And that's just the mix-up you'd have in accounting if you tried to decide each issue by itself.

When the Accounting Principles Board was formed in 1959 it was hoped that an accounting framework could be rebuilt that would avoid such situations. It was intended that the Board would produce—through the findings of research studies—a framework of basic accounting principles, conventions, postulates. Then as new types of business transactions or situations came along, they could be analyzed for their accounting characteristics and given treatment that fitted in with the framework already established.

But apparently this hasn't happened?

No, it hasn't, at least not to the extent that we had hoped. There are some reasons for this that now seem obvious.

The manpower requirement, for one thing, was great and the availability of competent people with time to spend on accounting research was small. This shortage exists to the present time. Partly for this reason, some of the research studies have been undertaken by accounting firms. Also, as it turned out, we really didn't have in any one place an inventory of accounting principles as they currently existed, and this has had to be compiled. Then, too, the Board hardly had time to get started on these basic studies when current accounting questions raised by new business situations had to be answered. The investment credit was one of these, but it has been followed by a number of others — accounting for financing leases, for example — each of which needed answering urgently, even before the basic framework could be established.

These problems of time—and money—are ones that we can foresee solutions to. The new Accounting Research Association of the AICPA, which all accounting firms are asked to support, is a step forward. However, there is a problem that is less obvious but more fundamental. And it presents a real challenge. The Board has to find the proper relationship between deductive reasoning, which gives order and consistency to the structure of accounting theories, and the testing of theories for their practicability, which makes them useful. The Institute research studies published in the early 1960s dealt with important matters, pursued largely through deductive research. But a number of their conclusions have not been fully tested in practice or comprehensively appraised in relation to their usefulness. How to get this testing and appraisal is a pressing question.

Would you illustrate that?

The investment credit is an example where the testing has resulted in difficulties. And somewhat the same thing has just happened with the Board's pronouncement in 1966 that when a company issues convertible debt there should be an accounting for the value of the conversion privilege. That was in paragraphs 8 and 9 of Opinion No. 10. The questions that have been raised in the testing are so substantial that the Board has withdrawn the effectiveness of these paragraphs pending further study.

I don't mean to imply by this that the APB should not take positions in new areas, and certainly it should continue to push for a narrowing of differences. What I am saying is that to avoid disorder the process must go forward at a pace which permits thoughtful consideration of intertwined complexities. I think this was done with Opinion No. 8 on pension cost accounting. We moved forward—not as far as some would have liked, possibly—but with consideration of all factors and close attention to what would be useful in practice. And I think that Opinion has accomplished significant accounting improvement in a highly complex area.

You mention "highly complex area." Does solving accounting problems get tougher the more complex the business transaction?

Usually, because the more complex the transaction, the more areas of accounting principles it is likely to affect. On the other hand, the conceptual area involved may be relatively clear-cut and yet prove the most difficult hurdle to get over — because the accounting framework I talked about before has not been fully developed.

We must always remember that accounting is not an end in itself—it is useful only when it is communicating business information. And communicating means that the person on the receiving end has to understand what is being told to him.

Isn't that another of accounting's big problems, trying to communicate with people who don't understand accounting?

Yes it is. There are so many levels of understanding and such a diversity of needs: those of the "average" stockholder, the banker, the financial analyst, the management accountant. Take the investment credit again. Under the flow-through method there is no question that a company's income is going to be affected by the ups and downs of the amounts of credit to which it is entitled. And the person who reads only the net income line in the income statement is going to suppose the ups were good years and downs were bad years. On the other hand, under the deferral method, that same person is going to see income recorded in future years that really has no relation to operations of those years.

I think we have always gone on the presumption that the responsible reader of financial statements can be properly charged with reading them in total. Now, maybe we should be easing away from this presumption, but in any event, our efforts should be directed toward greater clarity in accounting presentations. There is also much we can do toward explaining accounting matters to non-accountants. If we do this with enthusiasm we can accomplish a great deal.

But will there ever be an answer for the person who just won't read anything but the last line?

Oh, that may be possible. We have of recent years been greatly preoccupied with measuring income. This is where our most useful service has seemed to be, just as fifty years ago measuring balance sheet values seemed most important. It is quite conceivable to me that we could, however, in the evolution of our goals, turn to measuring earning power—a trend line of income rather than income by itself, within stated limits and specified reliability, of course. That could give the "average" stockholder a useful figure on one line.

How far in the future might that be?

Well, I'd say still pretty far. But it is illustrative of the wide future accounting has. That is why we should not find ourselves oppressed by single issues like the investment credit that seem difficult to solve. For every such question that comes before the Board there are hundreds that are being answered quietly and effectively by companies and their accountants within the framework of concepts that have already been established.

I think we should remind ourselves that our profession has undertaken a very major responsibility in our social and economic structure. Recognizing that, we should expect the issues we deal with to be big ones, too.