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TIPS FOR BUSY READERS

MARILYNN G. WINBORNE, CPA

"Accounting Improvement: How Fast, How Far?" Leonard M. Savoie, Harvard Business Review, July-August, 1963

Mr. Savoie, partner in Price Waterhouse and Co., quickly states his belief that accounting must be improved. These improvements will come from practice in an "accelerated evolutionary process" based upon principles found to be useful in the past. A part of the improvement will be the narrowing of the gap between divergent acceptable practices. Greater comparability among statements is a must and can be achieved, partially, through upgrading the professional standards of integrity and competence.

Comparability is not to imply uniform rigid procedures. "Accounting principles must be flexible enough to meet the demands of reality, thus permitting the adoption of appropriate methods that will make accounting relevant and responsive to the *particular* entity, the *particular* corporation, rather than to some nameless and faceless mass." Leaders in the profession are criticizing the current state of the art not so much to bring about evolutionary improvements in principles but "to remove from business management the right to participate in development of accounting principles and place this important function in the hands of an external regulatory body, either within the accounting profession or, failing that, within the government." The desired type of principles—flexible and geared to particular needs—can be developed only with the aid of business managers. Only with flexible principles can management report what is, in its opinion, fair.

The profession has a system by which its changes (improvements, hopefully) can be evaluated. The Principles Board's authority rests upon the general acceptability of its pronouncements. General acceptance, in turn, depends upon custom and practice, independent accountants' thinking, stock exchanges and the S.E.C. These checks and balances are too important to be discarded lightly.

There are four safeguards to the usefulness of financial reports: consistency, disclosure, conservatism and integrity. Using these to the fullest extent will aid the profession in the performance of day-to-day tasks as well as in evaluating new principles and procedures. The safeguards are not guarantees of uniformity. Their conscientious application would furnish a firm base for the many estimates and judgments necessary in financial reporting.

The future of accounting must encompass growth and change. The following recommendations are made to insure the "continued evolution of principles from the customs and modes of thought of the people."

(1) The AICPA should formally communicate with the business community as to principles.
(2) The Accounting Principles Board should accomplish its objectives by demonstration, not coercion.
(3) Practical research into known problem areas should be undertaken jointly by the profession and business managements.
(4) A plan for education of users of statements should be developed and implemented.

This article is a plea for practical, pragmatic "research" in accounting to be undertaken by accountants and managers jointly. Changes are to be evolutionary, not sudden. Growth is to be limited by extant practices. It appears that Mr. Savoie is advancing arguments for the *status quo.*

"Accounting for Costs of Capacity," N.A.A. Research Report No. 39. National Association of Accountants. 1963

The broad range of problems presented by fixed and semifixed costs is considered in this recent research study by the National Association of Accountants. N.A.A. "research" is pragmatic; the efforts of fifty-five companies are analyzed for common and complementary procedures in defining, reporting, and analyzing capacity costs. The report is lengthy, but it can and will be easily read by persons having diverse accounting backgrounds.

The generic term, capacity costs, is defined as those costs incurred in anticipation of future activity. This class of costs includes fixed costs which do not vary directly (in the short run) with production or sales and period costs which expire with the passage of time. The terms, fixed and period costs, are not used because they emphasize cost behavior while the term, capacity cost, stresses the origin of the cost. Expenditures for buildings, machinery, advertising, marketing research, administrative staff, and computers are all included in the term, capacity costs.

Capacity costs are broken down into two subclasses: (1) committed costs and (2) managed costs. Committed costs are those which remain constant over a relatively long period

of time (e.g., buildings). Long-range planning is required to control and coordinate committed costs. The study pointed out that estimated sales trends are the basis for decisions concerning committed costs. Management must plan the rate of usage, seasonal fluctuations and permissible inventory levels over appreciable time periods to determine the level of capacity each committed cost will produce.

The term, managed costs, is not so familiar nor are its components so easily defined. Managed costs are those which can be controlled from year to year by direct decision. The periodic budget is the main instrument for control of managed costs. Managed costs include purchased services such as research, staff, rent. Direct labor may be partially a direct cost and partially a managed cost when management is loathe to dispose of a core of workmen during a slack season; but the office staff may remain constant over short time periods regardless of the level of activity.

Changes in rates and methods of usage affect some capacity costs and not others. In the preparation of data to evaluate alternatives, it is preferable to show only those costs which will fluctuate. The greater the use made of available capacity, the greater the profits may be. This study reveals that accountants generally do not concern themselves with measuring or reporting capacity utilization. Capacity is defined "as the full output that can be sustained under attainable operating conditions." When capacity is known, it asserts, greater control can be exercised. The relation between scheduled production and current actual production is a measure of management's efficiency in using the facilities at its disposal.

Some costs of capacity are payments for services available only during specific periods (e.g., rents, salaries) and so are treated as period costs. Those costs which apply to several periods (e.g., buildings, machinery) must be allocated over the periods of usefulness. The various extant methods of depreciation will produce different periodic income. Allocations of joint costs do not have to be made for purposes of comparing cost and profit margin data to guide decisions between alternatives; however, escapable costs should be used in such presentations.

This report has added another dimension to managerial reporting. The examples of data used to inform management of the actual utility of a capacity item will find application in many businesses.

"A Critical Study of Accounting for Business Combinations," Research Study No. 5. Arthur R. Wyatt, AICPA, 1963

This latest publication in the Research Series by the American Institute of Certified Public Accountants tackles the knotty problem of recording business combinations—purchases and poolings of interests. Professor Wyatt has provided, in the first pages, an excellent brief history of business combinations in the United States. Discussions on the motivations behind combinations include tax laws and anti-trust legislation. The pronouncements by the AICPA committee on accounting procedure are brought out in the text as well as reprinted in the Appendix. These parts of Study No. 5 are worthwhile in themselves as they put combinations into a historical perspective necessary for an understanding of current practices.

Professor Wyatt establishes that the "crux of the problem in accounting for business combinations lies in the determination of the value at which the assets and properties newly acquired or controlled should be accounted for in the records of the economic unit resulting from the combination." This definition of the major problem area is followed by discussions of the current practices and the rationales behind them. Inadequacies and inconsistencies of current practices are exposed and explained in the light of past pronouncements by the Committee on Accounting Procedure and of changing business considerations leading to combinations.

This foundation, so carefully constructed, leads to the two-part conclusion of Study No. 5. The first is a general conclusion justifying the inclusion of business combinations in the subject matter of accounting:

1. A combination is a business transaction of significance.
2. Accounting must reflect results of economic events relevant to the entity.
3. A combination is an economic event relevant to the entity.

Therefore, from 1 and 3, accounting must reflect the combination.

The manner in which the combination will be recorded depends upon the circumstances surrounding the combination. If one unit buys another unit (either through acquisition of assets or equities) the purchase method is applicable and the acquired assets are recorded at their exchange price. This method could not permit the continuance of the acquired entity's retained earnings. The examination of corporate statements led Professor Wyatt to state that most of the recent combinations were purchases and not poolings of interest.

If, however, the entities involved in the combination were of comparable size, a pooling might exist. In such an instance the accounting treatment would be determined by the new entity. If the pooling produced no real changes, then the combination would be the sum of its components. Usually, poolings

in recent times produce a new entity substantially different from its forerunners. This circumstance calls for a third method, called "fair value" pooling. This method is believed to be more applicable than the traditional pooling of interests method.

Fair value pooling presupposes the creation of a new entity by the combination which is not a purchase of one entity by another. The resulting new entity has, actually, entered into an economic transaction with the combining units. Thus, there has been a purchase of the existing assets and liabilities (or equities) by the new entity. From this line of reasoning, the new entity should enter the assets at their exchange or purchase price. The fair value method differs from the purchase method in that:

1. The assets of all involved entities are stated at their current exchange or market price.
2. No retained earnings are carried forward as befits a newly created entity (thus furnishing a "new start" for the created entity).

A modification of this last feature is allowed, grudgingly—the new entity can show as retained earnings the total retained earnings of the combined entities.

The implications of these proposed procedures upon earnings per share and book value computations are discussed. The problem of goodwill is considered in connection with the establishment of the purchase price of the acquired assets. Following Professor Wyatt's study there are six pages entitled "Another Look at Business Combinations" written by Robert C. Holsen. Mr. Holsen contributes further refinements of the definitions of "purchases" and "poolings." His discussions on the use of stock and treasury stock in combinations are well formed and of practical importance. Mr. Holsen's proposals on the treatment of goodwill may well open new avenues of inquiry.

How to Think Straight—15 Tips:

(1) Do your own thinking
(2) Think before you act
(3) Think objectively
(4) Think ahead
(5) Think hopefully
(6) Think things through
(7) Think charitably
(8) Check and double check
(9) Beware of your prejudices
(10) Take an honest look at your own faults
(11) Get beyond wishful thinking
(12) Don't overlook the obvious
(13) Think with determination
(14) Look out for details
(15) Dig for the deeper meaning

—Christopher News Notes
October, 1963

STATEMENT OF OWNERSHIP, MANAGEMENT AND CIRCULATION (Act of October 23, 1962; Section 4369, Title 39, United States Code)

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Name, American Woman's Society of Certified Public Accountants, 327 South LaSalle Street, Chicago, Illinois 60604; American Society of Women Accountants, 327 South LaSalle Street, Chicago, Illinois 60604.

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9. Paragraphs 7 and 8 include, in cases where the stockholder or security holder appears upon the books of the company as trustee or in any other fiduciary relation, the name of the person or corporation for whom such trustee is acting, also the statements in the two paragraphs show the affiant's full knowledge and belief as to the circumstances and conditions under which stockholders and security holders who do not appear upon the books of the company as trustees, hold stock and securities in a capacity other than that of a bona fide owner. Names and addresses of individuals who are stockholders of a corporation which itself is a stockholder or holder of bonds, mortgages or other securities of the publishing corporation have been included in paragraphs 7 and 8 when the interests of such individuals are equivalent to 1 percent or more of the total amount of the stock or securities of the publishing corporation.
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I certify that the statements made by me above are correct and complete.

Beatrice C. Langley
Business Manager