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"But how valid is the 'cost' of an asset if it is assumed that whoever purchased it acted irrationally?"

"Although rarely expressing it, accountants assume that all of a firm's expenditures are made on a rational basis, i.e., to increase or maintain profits."

"Computers have the capacity to store data, to manipulate data, or to combine old data with newly entered data. . . . . . However, the computer must always be told exactly what to do."

EDITOR'S NOTES

The role of the accountant is continuing to grow and expand—this is certainly not a time when we can relax and hope to get along on the knowledge acquired even a few years ago. Newspapers have called the Tax Reform Bill of 1969 an accountant's dream (or nightmare?); the AICPA's Accounting Principles Board has a heavy agenda and is pressing to adopt two controversial new opinions (while many of us are still grappling with APB 15 "Earnings Per Share"—and with some of the earlier Opinions!); and the computer whirs on, spewing out information faster than it can be digested.

We are delighted to read newspaper articles that indicate that the demand among college recruiters for accounting majors is continuing to be high. Some studies have indicated that the greatest demand among master's candidates will be for accountants, certainly a reflection of the increasing complexities of our business world. Perhaps the gap between the college student and the businessman is not as great as we thought!

"The" topic of 1970 seems to be ecology—we are faced with grave problems in the area. It is with interest we note that AICPA President Louis Kessler has urged the accounting profession to join in an attempt to apply "systems management" techniques in solving on a national basis the problems of air and water pollution.

You will note that this month's Tax Forum is longer than usual—almost a necessity as a result of the importance of the Tax Reform Bill of 1969 and the complexities of certain provisions. We particularly invite your attention to the portion of the column dealing with lump-sum distributions from qualified employee benefit plans. If you are at all involved in such a plan—as an employer or an employee—we believe this should be high on your priority list of readings.

As this is written, the Accounting Principles Board of AICPA has two potentially far-reaching proposed Opinions which have been "issued for comment from persons interested in Financial Reporting." Comments are to be received by the APB on the two drafts by about the time this issue reaches its readers.

The first, issued February 16, 1970, is "Changes in Accounting Methods and Estimates." As presently drafted, the Opinion states that accounting changes may be made only if events occur which make a previously-used method inappropriate (and disclosure of the reason that the change produces more useful results must be made); that changes must be applied retroactively (with restatement of prior years' statements); and that the effect on net earnings and earnings per share for all periods must be shown. It would be effective for periods beginning after December 31, 1970.

The second, "Business Combinations and Intangible Assets," was issued February 23, 1970. This proposal establishes stringent guidelines which must be met if a business combination is to be accounted for as a pooling. It also establishes ground rules for the recording of costs of intangible assets and for their amortization. This proposal is planned to be effective after June 30, 1970.

Both proposals have already created considerable discussion in financial circles and, if adopted, will have tremendous impact on accounting. Our readers are urged to become familiar with the contents of the drafts and to watch their daily newspapers for results of the Board's action on these matters.

Your editor has recently encountered a new magazine which may be of interest to our readers. In its second year of publication, it already has undergone a name change and is now CORPORATE FINANCING. Among the articles in the January-February 1970 issue are "The Big Eight Accountants: How Far Should They Go," "The EDP Crisis—How the Computer People Will Challenge Your Authority," and "The Corporate Economist."

Much of this column seems to be devoted to a plea to read—we sympathize completely with our readers who contend "there is no time" but insist that it is the only way to stay abreast of the fast-moving developments in this profession. To not read is to lose ground steadily and rapidly; to get ahead demands extensive reading.

IS IT RATIONAL TO ASSUME RATIONALITY IN BUSINESS?

The author challenges a basic concept underlying the workings of business; perhaps you, too, will wonder about some of your business decisions—and about some of the financial statements you prepare or read.

Ula K. Motekat, CPA
Amherst, Massachusetts

The beginning student of economic theory is usually completely bewildered when he is told to assume perfect competition. For, in economics, it means perfect knowledge of the market by everybody, innumerable buyers and sellers, and complete substitutability of products.

If he is the questioning type, he might ask himself whether Mustangs, Cougars, and Barracudas can be substituted for one another. After all, they are all animals. But if the commercials are correct, the similarity ends right there and substitutability goes out the power window.

The innumerable buyers do not present a problem (at least not to the student who deals with them only in the abstract), since there are millions of animal lovers and car buyers. But innumerable sellers?—that is too ridiculous to be contemplated, even by a beginning economics student, for doesn't Detroit have a corner on the market?

And perfect knowledge? No one could stay in his right mind if he visited all the pet shops (and car dealers) in town without a detour to his friendly psychiatrist.

Just when the economics student has come to the conclusion that the ivy-covered econ prof has turned off and dropped out, he is told that perfect competition is, alas, virtually nonexistent in America. It is, however and nevertheless, useful for the model building that goes on in economics textbooks (and will appear on the next examination) even if it is not applicable to the real world of General Motors, U.S. Steel, and IBM.

The beginning *business* student is usually not that fortunate. He is rarely told that most disciplines in the business college assume rationality on the part of business—and he is seldom, if ever, asked to think about the consequences of removing that assumption.

What basis is there for assuming rationality in business? What happens if that assumption is removed?

Is the Investor Rational?

A very obvious example to illustrate the student's dilemma is the stock market. Numerous finance textbooks devote many pages to the various rational methods of arriving at the value of a share of common stock (in an almost perfectly competitive market, as the economics professor was happy to point out). Prominent among these methods are the more or less incomprehensible equations which, due to the profusion of sigma and delta symbols, are all Greek to the student. In this rational stock market, the value of one common share is equal to all sorts of fractions which do—or do not—include, either above or below the dividing line, dividends per share, earnings per share (both primary and fully diluted), market capitalization rates, and growth factors

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Miss Motekat taught for three years at the University of Colorado while a doctoral candidate in the fields of accounting, finance, and policy. She is now completing her dissertation on legislation in Great Britain and West Germany affecting income accounting and income determination.

Miss Motekat is a member of the American Institute of Certified Public Accountants, American Accounting Association, AWSCPA, and ASWA. She is currently serving as Associate Editor of THE WOMAN CPA and has had three articles published in previous issues of this magazine.

—some of them being present actual figures, others representing future expected figures. The one thing most of these model builders agree on is that stock market prices will rise, resulting in capital gains to the stockholders, if profits are retained and earn at least the same rate of return as last year's net assets.

In simple statistical terms, this means that a positive correlation exists between book value and Wall Street's stock market quotation. And that, of course, is great news for the accountant!!

But abstract model building is one thing, economic reality is another. To bridge the gap between the two, many studies have been conducted to discover the correlation between actual stock prices and the researcher's pet formula. Several textbooks even go so far as to mention specifically that the rational investor should be indifferent as to whether the company's earnings are retained or paid out in dividends—assuming either no income taxes or identical tax rates for dividends and capital gains. But when this assumption is lifted (and that does happen every so often) and the existing higher ordinary income rates on dividends are included in the analysis, the inescapable conclusion is that the rational investor should definitely prefer retained to distributed earnings.

An arithmetical example can illustrate this line of reasoning—if a company retains one dollar of earnings and increases net income by seven cents, it realizes 7% on its investment, a fairly easy accomplishment for all but perfectly competitive enterprises. If the dollar is paid out in dividends and the stockholder is in the 30% bracket, he has only seventy cents left after taxes (ignoring the cost of hiring a psychiatrist or a CPA, depending on whether he does or does not prepare his own tax return). To get the same seven cent return, he must invest his seventy cents at 10%, a feat that might prove difficult even for somebody in the 30% bracket on a joint return. Given the lower capital gains rates, retained earnings have another advantage in the rational world of the finance textbooks—since the dollar of retained earnings increases the value of the stock by one dollar—according to most mathematical formulas—the investor will keep 75¢ of that dollar when he sells his stock and pays his capital gains tax of 25%. So retained earnings have two advantages: they save the investor's time in looking for profitable investments for his dividends and they save him money when he does sell his stock holdings. All this happens in a rational stock market among rational investors!

But what happens in the real world? The investor prefers dividends! In an often-cited study Oskar Harkavy[1] came to the conclusion that, other things being equal, the firm paying dividends enjoys a higher market price of its stock and a higher price-earnings ratio than the retentive firm. Cottle and Whitman found in their study of the relationship between earnings and market prices[2] that, from 1947 to 1955, rising stock prices were due to increases in the price-earnings ratios which were influenced by higher dividend payout rates, rather than by higher earnings. And lately there is a rumor that a good financial relations consultant can do wonders for the price-earnings ratio. One such miracle worker takes credit for increasing a client's price from nine to fifteen times earnings.[3]

In spite of this evidence that the real-life investor prefers dividends to retained earnings, the finance textbooks and journals have not relegated the rational investor to the footnotes and the appendices. On the contrary, they look for logical reasons for his preference for dividends. (Fortunately they do not stoop to rescuing their equations with the aid of the old cliché that women—who do own a lot of stock—are "naturally" illogical and irrational. And three cheers for them!) In their search for rationality in investor behavior they apparently remembered the "information content" of the Federal Reserve Bank's discount rate (which crops up in the money and banking textbooks), so they reasoned that dividends, too, must have an "information content." In their thinking, a cash dividend tells the investor that the company did, indeed, make a profit and has, in fact, neatly bundled stacks of greenbacks sitting in the bank vault. This means that a check for 50¢ is more convincing than the CPA's opinion on the financial statements with their million dollar cash balance and billion dollar profit. The inescapable conclusion is that either the CPAs have botched their public relations job—or the investor is not rational.

In view of the above (and because the author is a CPA), it does not seem logical to assume rational behavior on the part of the investor. In fact, the assumption of irrationality may be much more rational. Some investors use charts—the athletic ones wave their pen-

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[1] Oskar Harkavy, "The Relationship Between Retained Earnings and Common Stock Prices," *THE JOURNAL OF FINANCE,* Vol. 8 (September 1953), pp. 283-297.

[2] Sidney Cottle and Tate Whitman, *Corporate Earning Power and Market Valuation 1935-1955* (Durham: Duke University Press, 1959), p. 49.

[3] "The Art of Blocking That Take-Over," *NEWSWEEK* (December 16, 1968), p. 85.

nants and flags, while the sporty types chase after double tops and double bottoms. Others use a hot tip from the barber who just shaved Mr. Gillette, a whisper from the bartender who just served Mr. Seagram, an operation (surgical or otherwise) in the White House, or simply the "bigger fool theory." That well-known theory states that there will hopefully be a bigger fool to buy the stock at a higher price in the future. And that goes right to the heart of accounting.

Is the Accountant Rational?

Is it rational to assume that investors use published financial statements to make investment decisions? Accountants seem to assume that investors do—they never tire of cautioning statement readers against placing too much emphasis on that one "net income" figure. It is, after all, based on estimates and assumptions. The estimates most frequently mentioned are the useful lives of long-lived assets and the collectibility of receivables. The assumptions most often stated are the "going concern" and the "stable dollar." But does anybody ever voice the assumption of rationality?

What happens to accounting if it is assumed that business is not rational? The first notion to come under suspicion is the "cost" concept, a fundamental idea in accounting. Cost is so popular because it is objective, according to professional opinion. Its objectivity seems to rest solely on the fact that two people (or two hundred for that matter) can look at the same invoice and the check in payment for it and agree that this amount is indeed what was paid for the asset or service and is, therefore, its cost.

But how valid is the "cost" of an asset if it is assumed that whoever purchased it acted irrationally? Maybe the purchaser bought from AT&T (Acme Tambourine and Trampoline) because its salesman has been buying him martinis for years with nary an order (and wining and dining prospective customers must increase sales, otherwise the rational-acting sales department would do away with expense allowances). Or perhaps he bought from them because a neighbor, golf partner, or friend works for it, so it has to be a good firm. Or, simpler yet, that was the first company his fingers came to when they walked through the yellow pages.

The objectivity of cost rests also on the assumption that cost equals fair market value, as Curtis Stanley points out in his persuasive argument.[4] In other words, the amount paid for an asset constitutes its market price, whatever that is. Market price, to be valid, has to go back to beginning economics and the assumption of perfect competition. In that happy world of Adam Smith, no seller can ask a higher price because no buyer would pay it since he has perfect knowledge and knows therefore what "the" market price really is. That, obviously, is not the case in the American economy.

It is manifestly impossible to establish "the" market price of a pack of Brand X cigarettes. It varies from the 40¢ charged by the chain supermarkets, via the 60¢ asked by the speciality cigar store in the swank downtown hotel, to the $1.50 appearing on the bill from the Playboy Club. If there are several prices for a pack of cigarettes, is it rational to assume just one market price for a desk, an adding machine, or a wastepaper basket? The significance of the undepreciated balance of fixed assets in the balance sheet and the depreciation expense in the income statement is certainly impaired if it is admitted that the office furniture could have been bought at bargain basement prices or from an old customer who needed the order but charged a little more.

Hardly less important than the cost concept is the idea of an asset. A generally acceptable definition is advanced by Sprouse and Moonitz who state that assets are "expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction."[5]

Under this definition an oil well, a share of IBM, and the company's Barracuda all qualify as assets. And so does a patent. But what is the difference in future economic benefits between an invention coming out of some far-away ivory tower and one developed in the company's own laboratory as long as they both confer exclusive rights to that proverbial better mousetrap? Surely, the difference in patents is caused by the originality of their ideas (at least, that is the basis on which the U.S. Patent Office works), not by their method of acquisition. But in many company ledgers, the purchased patent is an asset and the homemade one is an expense.

Every businessman will agree that the major reason for employing bearded geniuses and subsidizing "Marcus Welby, M.D." or "The Tonight Show" is the improvement of future earnings. Yet, generally acceptable accounting principles sanction expensing these outlays

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[4] Curtis H. Stanley, "Cost-Basis Valuations in Transactions Between Entities," *THE ACCOUNTING REVIEW* (July 1964), pp. 639-647.

[5] Robert T. Sprouse and Maurice Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises* (New York: AICPA, 1962), p. 8.

when incurred, rather than capitalizing them as assets. The reason usually given by accountants for this treatment is that it is too difficult to separate the expenditures that will benefit the future from the ones that will not (and, besides, it's deductible *now* for tax purposes).

A nonaccountant (and sometimes even an accountant) could here draw the conclusion that the criterion for classifying an item as an asset is its ease of computation. But if that were so, then rent and utilities would be assets since they are the easiest things to compute. By now the thoroughly puzzled nonaccountant might decide that an asset must possess both characteristics—it must confer future economic benefits and it must be easy to compute. And then, lo and behold, homemade goodwill qualifies because it does confer future economic benefits and it is so easy to compute that it only appears in the intermediate, not the advanced, accounting textbooks.

Digging deeper, below the cost and asset concepts, one discovers the assumption underlying all of it. Although rarely expressing it, accountants assume that all of a firm's expenditures are made on a rational basis, i.e., to increase or maintain profits.

But how many bosses ever try to figure out whether a cute mini-skirted receptionist at \$25 more than a midi-skirted one contributes \$25 a month more to profits?

Who knows whether a genuine imported Persian carpet at double (or more) the price of a domestic nylon rug increases profits? Or whether executives make better decisions at solid walnut desks than they do at simple metal ones?

Does anybody ever sit down and figure out whether the profits made on orders resulting from bulk mailings offset the ill will created in people resenting the flood of junk mail? Or whether the capital asset acquired, a decision based on many 10-column sheets of marginal cost analysis prepared by the accounting department, was as profitable as had been estimated? (It should be pointed out here that computations of the profitability of prospective capital outlay occupy vastly more space in accounting textbooks than do retrospective comparisons.)

And how many accountants, owning a share of Litton or LTV, have questioned whether a merger (treated either as a pooling or a purchase, depending on which one produced the better-looking financial statements) was undertaken to increase profits or, as Galbraith would maintain,[6] to satisfy management's desire for job security and status in the business world?

What all this boils down to is the question—is it rational to assume rationality in business? After all, business consists of people. The man who smokes Brand X cigarettes because you can't take the country out of them may be the purchasing agent. The man who pays 25% interest on the installment contract for his color TV set because everyone in his neighborhood has one may be the financial vice-president. And the man who waters and fertilizes his lawn to make it grow faster so he can spend more time cutting and cursing it may be the management efficiency expert. Is it rational to expect all these people to shed their irrational attitudes and to become rational individuals the moment they walk into their carpeted corner offices and sit down in their swivel chairs?

[6] John Kenneth Galbraith, *The New Industrial State* (New York: The New American Library, Inc., 1968), pp. 181-183.

Today, top management—armed with computers and instantaneous retrieval capability—has to pass the word as fast as it's obtained, not unlike a classy third baseman must field a bunt—pick up the ball on a dead run and fire to first base in one smooth motion. No easy trick, to be sure. But there is a management tool gaining wide acceptance in industry that takes on the characteristic of swift and smooth communication—the decision room.

In essence, the decision room is a tool to seize and disseminate information to top management in the quickest and most effective way possible. It is a room different from the conference room because it is especially designed and equipped to tune in its users to only the important information required in sound decision making.

Working on the theory that perception is sharpened in direct proportion to the number of human senses affected, the decision room subliminally stimulates all five senses. In a phase, it manipulates an environment so that those in its realm collectively focus and communicate on only matters brought before them.

Decision Room—A "Cool" Medium,
Warren Moulds, GENERATION, Vol. 2,
No. 2, November 1969.

AUTOMATED DATA PROCESSING—PART III—EDP

Two previous installments have discussed the transition from manual systems to machine systems; in this installment the author discusses the faster machine systems—those which utilize electronic equipment.

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An automated data processing system relies on either mechanical or electronic equipment. Although mechanical or punch card systems offer significant advantages over manual systems, they require continuous human intervention and attention. The punched card system is limited because it is not capable of handling exceptions within a routine and because of its inability to make decisions in the course of processing. Mechanical systems are relatively slow and inflexible compared to stored program machines (called either computers or EDP equipment).

EDP (electronic data processing) equipment or hardware refers to the computer which performs the same functions as punched card equipment—but does it faster. Awad states, "Whereas both systems are made up of many individual pieces of equipment, the punched card system is not under a central automatic control as is the computer system."[7] A computer oriented system consists of several machines that work as one. It is capable of processing data received through a number of devices other than the punched card. Instructions are received by means of a program which is stored in the machine. It processes the unit record under the control of a control unit. All individual units are tied to the processor.

Description of EDP Hardware

Essentially the hardware consists of three parts—input, central processing, and output. Many of the input and output devices are the same and thus referred to as I/O devices. These I/O devices are the media with which man communicates with the computer. Common computer input or output can take the form of punched cards, punched paper tape, or magnetic tape. Additional input which will not be covered in this article could be a typewriter keyboard, magnetic ink character recognition, light probes, or line typewriters and remote input sharing stations.

The punched card is the same card as that previously described for use with mechanical equipment and it can be either input or output. Cards have the advantage of being easy to sort, delete, and replace without disturbing other cards. They are humanly readable and are useful as external storage medium for permanent records. However, cards cannot be folded, stapled, mutilated, bent, warped, or erased. They are bulky and slow.

A second input-output device is punched paper tape. Paper tapes are produced by special adding machines, typewriters, accounting machines, or cash registers. Like cards, tape is laid out in rows and columns, data is recorded on the tape by punching holes into it, and a character of information is represented by a punch or combination of punches in a vertical column across the width of the tape. Paper has the advantage of being easy to mail. It is a continuous length which prevents wasted space when records are short. However, paper tape has many disadvantages. It is not as durable or as convenient to store, file, or handle as the punched card; and it is difficult to delete or add information. Compared to magnetic tape, it is very slow.

Magnetic tape is a popular I/O medium for high speed, large volume applications. The tape is a plastic ribbon coated on one side with an iron-oxide material which can be magnetized. Business data are recorded in the form of tiny invisible spots on the iron-oxide of the tape by electromagnetic pulses.[8] The tape can be erased and used indefinitely. It can be encoded by a Magnetic Tape Encoder or data can be captured in punched cards or punched tape form and then transcribed on magnetic tape by a special offline data converter. Magnetic tape has the advantages of permitting an unlimited length of record, compact storage, and low cost. However, tape needs machine interpretation, lacks random accessibility, and needs care from dust and humidity.

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[7] Elias M. Awad and Data Processing Management Association, *Automatic Data Processing Principles and Procedures* (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1966), p. 130.

[8] Donald H. Sanders, *Computers in Business: An Introduction* (New York, New York: McGraw-Hill Book Company, 1968), p. 87.

In addition to the above described I/O devices, the primary output devices when the information is to be used by man rather than machine is the high-speed printer. It provides information output in the form of permanently printed characters similar to a typewriter output.

The third part of the hardware is the central processing unit. The central processor unit (CPU) contains the storage unit (often referred to as core), the arithmetic logic, and the control unit.

Storage (primary or internal) retains the program and the data which will be used during processing. This data can be numeric, alphabetic, or a combination of the two. Input to the computer is written in standard decimal or alphabetic form; however, it is converted into a code by the computer before being stored. This internal code is based on digits in various binary forms. The coded data is reconverted to decimal and alphabetic characters when printing is requested. Primary storage stores the data being processed and retains the results until needed. Because it is impossible for a computer to store all the data it needs internally, secondary storage or external memory is usually provided. Two common types of secondary storage are magnetic tape and magnetic disks. Magnetic tape is a sequential-file external storage medium as well as input medium and output medium. Sequential file means that the tape must be read in sequence; that is, the first record written on it must be read before the second record. As external memory, magnetic tape has the advantages of being compact, easy to handle, flexible, and low in cost. The drawbacks are its slow access time and the care required in tape handling and storage. Dust can cause errors. Heat and humidity destroy the data completely. The tape can break. When wound on the reel, the magnetic attractions can cause magnetic patterns on one coil to be copied on adjoining coils of tape within the reel.[9]

Magnetic disk is another medium of external storage. It is a vertical stack of magnetic metal disks similar to the records in a juke box. Disk storage is a random access file which has the ability to skip around within a file and read or write specific data without regard to sequence. Magnetic disk storage accommodates large amounts of data and has a low operating cost; however, the initial cost is high compared to magnetic tape.

The arithmetic unit must be present in addition to storage to perform the arithmetic and the logic of the computer system. Logical decisions of a computer are usually limited to the ability to tell if two numbers or characters are equal or unequal, if one number is greater or less than another, and if a quantity is positive, negative, or zero. The control unit causes the primary storage and the arithmetic logic unit to be used in a logical fashion.

Robichaud explains the procedure as follows, "The input device enters instructions and data into the computer storage unit which holds the data until needed for processing. The central processing unit performs calculations and logical operations on the data. The output devices record the data processed by the computer. The control unit coordinates the operations of the other devices."[10]

EDP Software

According to Sanders, "Until the processor is given a detailed set of problem-solving instructions, it is merely an expensive and space consuming curiosity."[11] It—the computer—aids man in his work, but it cannot replace him because it is dependent upon him for explicit instructions. Writing these instructions to computers is called programming and consists of two steps; flow charting the job and coding the flow chart into a language that can be understood by a particular machine.

A flow chart is a means of presenting information and operations so that they are easy to visualize and to follow. There are two kinds of flow charts—system flow charts and program flow charts. System flow charts are primarily designed to show the flow of data through the entire data processing system, and symbols representing input, output, and general processing are frequently used. A program flow chart, on the other hand, presents a detailed graphical representation of how steps are to be performed within the machine to produce the needed output. The program flow chart is necessary for a computer oriented system and evolves from the system flow chart.[12] After the program flow chart is drawn and the logic checked, the program is coded in machine language, Autocoder, Cobol, Fortran, PL/1, or some other language. Although these are all languages with which man communicates with the computer, machine language is the only

(Continued on page 16)

[9] Elias M. Awad, *Business Data Processing* (Englewood Cliffs, New Jersey, Prentice-Hall, Inc., 1965), p. 183.

[10] Beryl Robichaud, *Understanding Modern Business Data Processing* (New York, New York: Gregg Division McGraw-Hill Book Company, 1966), p. 112.

[11] Sanders, *Computers in Business: An Introduction*, p. 187.

[12] *Ibid.*, p. 189.

THEORY AND PRACTICE

Current Studies and Concepts

EILEEN T. CORCORAN, CPA, Special Editor
Arthur Young & Company
Chicago, Illinois

REPORTING WHEN A CERTIFIED PUBLIC ACCOUNTANT IS NOT INDEPENDENT

The Committee on Auditing Procedure, a senior technical committee of the American Institute of Certified Public Accountants, has issued Statement on Auditing Procedure No. 42 entitled as above. The purpose of the Statement is to clarify the position of the certified public accountant when the accountant is considered not independent with respect to a client with whose financial statements the accountant is "associated" (this term is explained in a previous pronouncement, SAP No. 38, "Unaudited Financial Statements," paragraph 3) and to specify the type of disclaimer of opinion which the accountant should express in such circumstances.

It states that when an accountant is not independent, the accountant should disclaim an opinion with respect to the financial statements and should state in the disclaimer that the accountant is not independent. The Statement provides that the reason for lack of independence should not be described in the disclaimer as including the reason might confuse the reader concerning the importance of the impairment of independence. As provided in the profession's rules of conduct, whether or not the accountant is independent is something the accountant must decide as a matter of professional judgment.

The recommended disclaimer of opinion, regardless of the extent of services performed, is as follows:

> "We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19__ and the related statement(s) of income and retained earnings for the year then ended were not audited by us; accordingly, we do not express an opinion on them."

The Statement states that each page of the financial statements should clearly and conspicuously be marked "unaudited—see accompanying disclaimer of opinion," unless the disclaimer of opinion appears thereon. Moreover, it provides that any procedures that may have been performed by the accountant in connection with such financial statements should not be described in the disclaimer of opinion—as to do so might cause the reader to believe that the financial statements have been audited.

The Statement provides that if the accountant concludes, on the basis of facts known to the accountant, that the financial statements with which the accountant is associated are not in conformity with generally accepted accounting principles (which include adequate disclosure) the accountant should insist upon appropriate revision and that if the accountant fails to obtain such revision, the accountant should set forth clearly the reservations in the disclaimer of opinion.

It provides that the disclaimer should refer specifically to the nature of the accountant's reservations and to the effect, if known to the accountant, on the financial statements. Moreover, it provides that if the client will not agree to the appropriate revision or will not accept the accountant's disclaimer of opinion with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement.

ACCOUNTING TRENDS & TECHNIQUES

Annually the American Institute of Certified Public Accountants issues "Accounting Trends & Techniques." This publication discloses significant accounting trends as revealed in annual reports of industrial and commercial corporations. Numerous tables are presented showing current trends in types of financial statements presented, their form and terminology, and the accounting treatment afforded transactions and items reflected in the statements. Substantially the same companies' annual reports, 600 in all, are surveyed each year. Some items of interest in the current edition are:

1. 458 of the 600 companies surveyed present all of their 1968 financial statements in comparative form, 96 present all statements other than the statement of source and application of the funds in comparative form, and 45 present all statements other than statements showing equity changes in comparative form.

Only 1 company did not present its 1968 balance sheet and statement of income in comparative form.

2. Accountants' reports covering the statement of source and application of funds increased from 273 in 1965 to 443 in 1968. Companies not presenting such a statement either as a basic financial statement or as supplementary information decreased from 142 in 1965 to 65 in 1968.

3. Companies showing amounts in their financial statements to the nearest thousands of dollars increased from 25 in 1960 to 180 in 1968.

4. Companies not referencing the notes to financial statements to specific captions in the statements but merely including a general reference on the statements to the notes (such as "see accompanying notes") increased from 78 in 1960 to 164 in 1968.

5. Companies showing profits by division or by product lines, etc. increased from 21 in 1967 to 93 in 1968. In addition, the number of companies showing *sales alone* by division or product lines totaled 161. Generally all this information is in the narrative section of the annual report rather than in the financial statements.

6. 97 of the surveyed companies did not disclose their depreciation policy. Of those disclosing their policies, 451, 77, and 50 used either in part or in total straight line, declining balance, and sum of the years digits, respectively. 80 of the companies using accelerated methods did not specify the accelerated method or methods used. In addition, 138 companies indicated that their depreciation tax provision agreed with the book provision and 430 indicated that the tax provision differed from the book provision. Of the 430, 227 indicated the depreciation method being used for tax purposes.

7. Companies disclosing the reasons for inter-period tax allocation increased from 265 in 1967 to 353 in 1968. The most common reason given for allocation was depreciation.

8. 163 companies in 1968, compared with 112 in 1967, disclosed extraordinary items. The most common items disclosed were the sale or other disposal of assets (113) and disposal of discontinued operations (47). It is interesting to note that the ratio of the extraordinary items to income before extraordinary items was 0 to 5% in 45 of the cases, 6 to 10% in 60 cases, 11 to 20% in 42 cases, and 21% or greater in 90 of the cases. Items classified in "Accounting Trends & Techniques" as extraordinary items but not so classified in the income statement totaled 35 in the 0 to 5% category, 5 in the 6 to 10% category, 3 in the 11 to 20% category, and 2 in the 21% or greater category.

9. The most common reason given in the surveyed reports for prior period adjustments was poolings of interest. These increased from 49 in 1965 to 184 in 1968. The next most common reason given was changes in accounting policy. These increased only slightly from 38 in 1965 to 44 in 1968.

This year's edition includes as a new feature a "composite" set of financial statements, illustrating the most frequent presentations used by the 600 survey companies in their 1968 balance sheets and statements of income, retained earnings, and additional capital. A list of the notes to financial statements that are most frequently presented is also given. These relate to:

a. Acquisitions and consolidation policy
b. Inventories
c. Depreciation
d. Income taxes
e. Long-term debt
f. Stock options
g. Pensions
h. Commitments, contingencies, and long-term leases.

The income statement illustrated is in the one-step format.

TWENTY-FIVE YEARS AGO—in THE WOMAN CPA

The questioner wanted to know if it was still considered good practice to include a statement of application of funds in an audit report. All three answers were in favor of such inclusion, although one stated that his firm used it with discrimination when it was felt to be of value to the client. Our reader feels that the doubt about the advisability of using a statement of application of funds in a report probably arises because of the form usually used for such statements.

"It is, of course, a form of cash statement. However, many businessmen have told us that it gives them a comprehensive review of their business activities in a quickly read, condensed form."

"The Idea Exchange"
August 1945

TAX FORUM

ANNE D. SNODGRASS, CPA, Editor
Texas Instruments Incorporated
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THE TAX REFORM ACT OF 1969

The Tax Reform Act of 1969 was signed into law by the President on December 30, 1969, after a traumatic and stormy trip through the House of Representatives, the Senate, and finally the phenomenal reconciliation in the Conference Committee. While some of the provisions were given vast publicity throughout the entire struggle, others were the result of last-minute floor amendments in the Senate, and then the final twists were the result of the Conference Committee's effort to iron out differences and produce a Bill which would be acceptable to President Nixon.

As a result, many of the provisions are not adequately backed by Committee Reports and cannot be interpreted by the most expert of tax professionals, or even Treasury Department personnel, without implementing regulations, temporary rulings, and a great deal of guesswork. Some of these provisions will affect 1969 tax returns and 1970 fiscal year returns—effective dates include April 18, 1969; April 22, 1969; July 25, 1969; July 31, 1969; October 9, 1969; and even December 19, 1969. It can be expected that the tax returns which are prepared this year before the regulations and rulings are issued will be subject to some amendments and adjustments on audit.

The primary effort in this column for the next few issues will be to cover those items of general interest which will affect tax returns prepared for 1970 and initially to cover the items which will require changes in accounting procedure before year-end in order to comply with 1970 reporting and filing requirements. Rather than explaining the obvious, which is adequately covered in other publications, there will be an effort to point out the pitfalls which exist for the unwary.

Two sections which will require some immediate accounting and reporting changes during 1970 are Section 515, dealing with the taxation of lump-sum distributions from qualified employee benefit plans, and Section 231, liberalizing deductions for moving expenses. Some caveats relating to these provisions follow.

Lump-sum Distributions from Qualified Employee Benefit Plans

Section 515 of the Tax Reform Act, amending Sections 402, 403, and 72 of the Internal Revenue Code, limits the long-term capital gain treatment formerly accorded lump-sum distributions from qualified profit-sharing, pension, stock bonus, and annuity plans and provides a special tax computation with respect to the portion which will be treated as ordinary income under the new provisions.

The new law limits the capital gain treatment of such total distributions to (1) the amount accrued to the benefit of the employee during plan years beginning before January 1, 1970, and (2) the portion of the benefits accrued to the employee after December 31, 1969, which the employee can establish are not his proportionate share of employer contributions made for plan years beginning after January 1, 1970. Forfeitures are to be treated as employer contributions for this purpose. The employer contributions and forfeitures after 1969 will be taxed as ordinary income, but will sometimes be eligible for a special averaging computation under Section 72 of the Internal Revenue Code.

The burden of establishing the long-term capital gain portion and the ordinary income portion of such distributions rests upon the employee-distributee. He will be obliged to keep records of amounts allocated to his benefit or individual account from 1970 forward unless the employer, or plan administrators, are kind enough to adjust their record-keeping to provide this information. In either case there are several problems to be faced in making the necessary determinations, and it would appear that employers are going to find it necessary to furnish employees with some sort of information to assist them with this determination.

First, it will be necessary to define how "benefits accrued" will apply to those benefits only partially vested at December 31, 1969; sometimes this will be a problem even where there is full vesting. This is particularly true under some pension and annuity plans where employer contributions are computed under an aggregate method of funding and are not allocated to individual employees. Even under those plans which do allocate contributions to the individual employees, there are some widely differing methods of funding such benefits which could affect the amount of "benefits accrued." Therefore, two employees receiving the same distribution, but from two different plans, could be subject to different tax burdens simply because of the method of determining the actuarial liability or contribution.

Another question which will affect the determination of the long-term capital gain and ordinary income portions of a total distribution will be the treatment of cash withdrawals which are allowed under some profit-sharing plans. In order for a plan to be qualified, any provision for cash withdrawals must limit such withdrawals to employer contributions made prior to the most recent two plan years; normally there will be other penalties (such as a forfeiture of a percentage of the withdrawal amount). The cash withdrawals are always taxed to the employee-participant as ordinary income in the year of receipt. Therefore, it may seem logical to assume that cash withdrawals would reduce the ordinary income portion of the final lump-sum distribution when the employee terminates. However, remember that cash withdrawals from profit-sharing trusts during 1970, 1971, and 1972 must come from pre-1970 employer contributions which are included in the long-term capital gain portion of the distribution. Also, it is conceivable that an employee who had never taken a cash withdrawal could take his maximum available withdrawal several years from now and thus withdraw both pre-1970 and post-1970 employer contributions. Some tax authorities feel that this is a problem which may never be covered by regulations, so trust administrators will have a decision to make which will affect the tax liability of plan participants.

The third problem of determination between the two types of income will occur when the employee takes his distribution either partially or fully in employer securities. Under the old law, the net unrealized appreciation in the employer securities included in a lump-sum distribution was not recognized until such time as the employee sold the securities. At the time of the distribution he paid tax only on the cost to the plan or trust, or, if the securities had been contributed to the plan, the tax was paid on the employer's cost basis. The new law attempts to preserve this treatment of the unrealized appreciation. The committee reports are clear that where the securities were contributed by the employer, the employer's cost basis will be treated as an employer contribution. If it is a post-1970 contribution, the amount of the cost basis will be treated as ordinary income upon distribution. However, there were no comments on what happens when the securities were purchased on the open market by the plan or trust itself. In this case, the possibility exists that the cost basis could be less than the amount of ordinary income portion of the distribution which the employee would have to report if he had taken his distribution in cash. There are two possibilities here. Either the employee will be required to report the full amount of the ordinary income element of the distribution and thus pay tax on a portion of the net unrealized appreciation in the stock, or he may be allowed to report as ordinary income only the cost basis in the stock distributed. This second alternative will allow him to effectively convert ordinary income to long-term capital gain. However, this still is the more equitable treatment because the employee, in electing to take his distribution in employer securities, has risked some capital which he could otherwise receive in cash. If the first method is required, the employee should then be able to establish a new basis in the securities.

In addition to the problems inherent in determining what is ordinary income and what is long-term capital gain, the employee-distributee then has the complication of computing his tax on the ordinary income portion of the distribution. For this computation, the authors of the Tax Reform Bill looked to Section 72(n) of the Internal Revenue Code which provides for a special five-year forward averaging rule for the computation of tax on lump-sum distributions to owner-employees under H.R. 10 plans. The five-year averaging was changed to seven years in the case of distributions under qualified plans, and certain other refinements were added. In order to be eligible for this averaging method, the employee must have been a participant in the plan for at least five "taxable" years prior to the taxable year of the distribution. His tax would then be the higher of (1) seven times the increase in tax resulting from the inclusion in his gross income of 1/7th of the ordinary income portion of the distribution or (2) seven times the increase in tax which would result if his taxable income for such taxable year equalled 1/7th of the amount by which the ordinary income portion of such distribution exceeds his personal exemptions. If he is at least 59½ years old, or has died or become disabled, the amount of compensation (other than deferred compensation) received from his employer in the taxable year of the distribution can be excluded in computing this tax. The amount of the long-term capital gain portion can be excluded from the computation regardless of his age.

The problem here, once you have learned to read the statute, is what to do with the standard or itemized deductions and personal exemptions in computing the tax on the ordinary income portion. Under the old H.R. 10 rules, the taxpayer was not allowed to exclude any of his income in making the computation, so the only time the second alternative above would result in a higher tax was when the taxpayer had a loss which brought his taxable income below the amount of the distribution. Now we have a situation which allows, under certain circumstances, the exclusion of a substantial portion of the distributee's income during the taxable year of the distribution. If he is allowed to deduct all of his personal exemptions and standard or itemized deductions from that income included in the computation, his resulting tax may frequently be lower than that which he would have paid had the entire distribution been taxed as long-term capital gain. Persons faced with tax planning problems in this area should recognize that the IRS regulations may require the apportionment of deductions and exemptions between the excluded portion of the income and the portion that is included in the computation.

In addition to the provisions of Code Section 72 and Sections 402 and 403, there are other provisions in the Act which can impact the amount of tax liability on lump-sum distributions from qualified plans. The alternative tax on long-term capital gains has been increased, the minimum tax on tax preferences will apply to the 50 percent of long-term capital gain income which is not taxed, and the rules for general income averaging have been liberalized.

Employee Moving Expenses

The additional relief with respect to employee moving expenses included in the 1969 Tax Reform Act has been the subject of a great deal of publicity. As a result, most individual taxpayers eligible for this deduction will be well aware of their potential tax savings or at least partially aware that some relief was granted. Not so well-publicized were the changes in reporting requirements with respect to reimbursements for such moving expenses. As a result there may be some employers who will be caught short at the end of 1970.

Prior to 1970, reimbursements to employees for moving expenses which were allowable deductions were treated in much the same manner as travel and entertainment expense reimbursements where there is a complete accounting to the employer. The employee did not have to include the reimbursements in his gross income unless they exceeded actual expenses and he did not have to itemize the deductions on his tax return unless he had unreimbursed deductible items.

Section 231 of the Tax Reform Act not only amended Section 217, which allows moving expense deductions, but also added new Section 82 to the Internal Revenue Code. Under this new section, all reimbursements for moving expenses must be included in the employee's gross income, whether the reimbursement is paid directly to the employee or to some third party such as a moving company or real estate agent. The employer will not be required to withhold income tax from any reimbursement if, at the time the reimbursement is made, the employer can reasonably expect that a corresponding deduction for moving expenses is allowable to the employee. This means that the employer will have to withhold on all items not covered by Section 217 of the Code. Actually this has been a requirement for a number of years but has not been clearly defined and, therefore, the question of which reimbursements were income and which ones weren't has been litigated time and again. The employer is thus faced with a new obligation which may not be "relief" to him.

Code Section 217 now adds three new categories of moving expenses to the two "barebones" types which have formerly been allowed. These are the reasonable expenses (1) of traveling, after obtaining employment, from the former residence to the general location of the new principal place of work and return for the principal purpose of searching for a new residence, (2) of meals and lodgings while occupying temporary quarters in the general location of the new principal place of work during any period of 30 consecutive days after obtaining employment, or (3) which constitute qualified residence sale, purchase, or lease expenses. The overall limitation for the three new types of allowable expenses is $2500 and the total expense for the first two of these new categories cannot exceed $1000.

There apparently is no limit to the number of house-hunting trips for which expenses are deductible, but the statute is rather specific about the fact that it must be after the employee has obtained employment at the new location and that each trip must include a return trip to the former residence.

The second category offers some opportunity for maximizing allowable deductions. The allowance for temporary living expenses at the new location is limited to 30 consecutive days, but there is not a requirement that the deduction must be for the expenses incurred during the first 30 days. Therefore, if an employee is required to live in temporary quarters for a period exceeding the 30 days allowed, he should pick 30 consecutive days during which the highest expenses were incurred. Obviously, the temporary living expenses after the employee's entire family arrives at the new location will be higher than those incurred by the employee temporarily alone. Anything he deducts will be subject to the dollar limitation mentioned above.

Any expenses deducted under Section 217 in connection with selling his old residence cannot be used to reduce the amount realized on the sale of the residence for the purposes of determining gain. Nor can expenses deducted under Section 217 in connection with buying a new residence be added to the cost basis of the new residence. If he is faced with the possibility of going over the dollar limitation on his Section 217 deductions, the employee may want to do some advance planning for the purpose of determining which expenses might do him the most good where. He may derive some benefit in the future by deducting the expenses on the sale of his old residence and capitalizing the excess expenses incurred in purchasing the new residence. On the other hand, if he is in a position where he has to report some gain on the sale of the old residence, it may be beneficial to use the expenses related to such sale to reduce the gain.

The old law required that the distance of the employee's new principal place of work must be at least 20 miles further from his residence than the old place of work. The new law requires a distance relocation requirement of 50 miles. However, rather than being measured by a straight line on the map, the 50-mile test is now measured by the shortest of the more commonly traveled routes between the two points. This is clearly a help to those people who might be moving across a bay, or lake, or mountainous area where roads seldom go as "the crow flies."

The new moving expense deductions are not only available to employees, whether or not they are reimbursed, but is also now available to self-employed persons. The rules relating to self-employed persons are the same as those outlined above except for the "time" test which requires that an employee must be employed full-time at the new location for at least 39 weeks during the first year following his arrival. For the self-employed, the "time" test is 78 weeks out of the first 24 months immediately following his arrival at the new location. No less than 39 weeks must fall within the first 12 months.

The moving expenses are deductible in arriving at adjusted gross income and may be taken whether or not the taxpayer elects to take the standard deduction. A statement itemizing such expenses must be attached to the taxpayer's return.

If you feel that some of the provisions of the Tax Reform Act are unnecessarily complex, you might check out some of the provisions of the original House Bill which were deleted. The Senate Finance Committee explained their reason for deleting those provisions proposed to deal with deferred compensation as follows: "The Treasury Department recommended that this provision be deleted from the bill. . . . The Treasury also indicated there are a number of problems in the practical operation of the provision which it believed had not been solved satisfactorily." Long live the Treasury Department!

AUTOMATED DATA PROCESSING—EDP

(Continued from page 10)

one the machine understands.

The coded sheets are given to a key punch operator, who punches the data from each line on a separate card. If the coding sheet contains 20 instructions (lines), when 20 cards are punched. This deck of cards is referred to as the source program. After it is checked, the source program is taken to the computer and a separate program called a compiler deck is placed in front. The compiler deck, the source deck, and a deck of blank cards are loaded in the computer. The computer translates the source deck into machine language and punches out an object program on a deck of cards, on paper tape, on magnetic tape, or on disks. After the object program or machine language deck is tested for accuracy (debugged), the program is ready to use with live data. The object deck is put in the hopper of the card reader punch, followed by the deck with the data. The object program can be used over and over again whenever the application for which it was written is repeated.

Computers have the capacity to store data, to manipulate data, or to combine old data with newly entered data. The computer can do simple operations rapidly and repetitively; it is accurate; and it almost always operates at full efficiency. However, the computer must always be told exactly what to do. This means programming the machine by flow charting the job and coding the flow chart.

To be concluded

REVIEWS

Writings in Accounting

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"THE MISSING LINK IN SUPERVISION OF THE SECURITIES MARKET," R. J. Chambers, ABACUS, Vol. 5, No. 1, Sept. 1969.

In this most recent addition to a lengthy list of publications, Professor Chambers continues his verbose but enjoyable campaign to revitalize financial accounting. From a study of take-over bids of seventeen Australian firms (see ABACUS, September 1965), Chambers produced empirical evidence that the shareholders were not properly informed in these instances. As one could expect from his past writings, Chambers contended that more rational decisions could have been made by the shareholders had they been provided with financial statements (of which the balance sheet is an equal partner) based on a current cost basis.

As the title suggests, this article builds a case for the assertion that the regulations governing the securities markets in the United States and the United Kingdom are inadequate to prevent "uninformed or misinformed action on the parts of buyers and sellers" of interests in corporate equities. The inadequacies exist not so much because of what is required, but because of what is not required. The case is built upon a logical, common sense analysis of the purpose of security markets and their regulation by society and upon the informational needs and potential conflicts of interest among the various groups operating in the securities market.

The securities market serves two functions—allocative and redistributive. For the market to operate in a socially acceptable manner, all parties involved must be equally well informed. In the U. S. the Securities Act of 1933 specified the use of original cost in balance sheets. This was a reaction against assumed (but not supported by the facts) revaluation abuses in the immediately preceding years. The prescribed adherence to cost produces statements inconsistent with real business results and positions thereby producing anomalie. Cost is sidestepped in the balance sheet presentation of inventories at lifo, through the "creative bookkeeping" procedure of increasing earnings per share by slowing down the depreciation rate, and by improper tax allocation and lease capitalization.

Legislation in the U. K. has never barred asset revaluation; such practice is optional, which does not enhance intercompany comparisons. Examples are given of the resultant anomalies created by this form of legislation.

The legislation governing the securities markets in the U. S. and the U. K. has as its goal "fair representation in the interests of investors, creditors and a fair market." The remoteness of investors appears to have been overlooked as well as "the allocative function of the market and the pertinence to it of up to date information." As long as managers can pick and choose the accounting methods to be used, shareholders and society are not protected from misallocation of resources.

The missing link in the protection of shareholders is the absence of the requirement that all assets be shown at current resale value. This "is the one piece of information which pins all expectations and opinions to the facts of the market place, where buyers and sellers, issuers and brokers, borrowers and lenders make their play and their profits and losses. It is linked to every interest and is essential to the informed judgment of every party of interest."

A brief review can not capture the pleasing literary style of Professor Chambers (which more accounting authors would do well to emulate) nor the neatness of his analysis. Everyone interested in the future of accounting should read Chambers.

Dr. Marilynn G. Winborne, CPA
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"DOCUMENTATION STANDARDS," Max Gray and Keith R. London; Brandon/Systems Press Inc., Princeton, New York, 1969; 171 pages.

Our accounting profession has taken tremendous strides in the past few years in an attempt to utilize data processing equipment. This utilization has been concerned with the traditional responsibilities of the accountant as well as the new responsibilities of providing information for planning and decision-making. This addition to the scope of the accounting function, along with an increasing growth in the complexity of our society, has increased the importance of documentation in the information system.

In recent years accountants have had references for documentation of traditional accounting systems but not for data processing systems. "DOCUMENTATION STANDARDS" pertains to data processing systems and is a good reference for this phase of the accounting function.

As stated by the authors, the primary objectives of this book are:

1. to define the purposes and types of documentation and to assign responsibilities for preparatory review and approval of documentation—
2. to describe the roles and content of documentation within systems development—
3. to show the importance of documentation in project control—
4. to emphasize the importance of documentation standards and to outline methods of developing these standards—
5. to outline a model documentation system.

Chapters 1 and 2 contain a discussion of the "Background to Data Processing Documentation" and "Documentation in a Working Environment." A distinction is made here between development documentation, which describes the system, and control documentation, which contains information about project development organization, personnel, time, materials, and money. Thus, documentation is discussed from a "purpose" point of view and the environmental considerations in that "purpose."

Chapters 3—7 contain discussions of the various components of development documentation. These components are described as "Analytical Documentation," "System Documentation," "Program Documentation," "Operations Documentation," and "User and Management Aids."

Control of documentation is then discussed, which includes project control descriptions, the documentation library, and maintenance and the development of documentation standards.

It seems to this writer that control documentation should be considered before descriptive documentation, but it is realized that in practice both types are designed and prepared somewhat simultaneously.

This book is technical in that it contains examples of various documents, but it is written on a level that anyone can understand. It is not a "textbook type" book but is a reference book and contains many ideas and examples which would serve to help strengthen the documentation in any system. Anyone interested in data processing or systems would consider her time well-spent in referring to this book.

Dr. Dora Herring, CPA
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"ACCOUNTING FOR INFLATION—A FIELD TEST," Paul Rosenfield, JOURNAL OF ACCOUNTANCY, June 1969, Volume 127, Number 6.

In 1961, the Accounting Principles Board started a program to determine "appropriate accounting under conditions of inflation." This article deals with the results of price level adjusted statements prepared by 18 United States companies for two different years.

The author first discusses the objectives of general price level financial statements. He explains that they show "changes in the general level of prices . . . (not) changes in specific prices of goods and services." He discusses the gains and losses resulting from holding monetary items such as cash, receivables, and payables during inflation.

The article then tabulates five items for each of the 18 companies. (The companies are identified only by alphabetic letter.) These are net income, general price level gains and losses, federal income taxes, cash dividends, and rate of return on ownership.

The results of the study indicate that inflation does not affect all financial statements in the same way. Some companies showed increased net income while others showed decreased net income. There was also a "ballooning" effect on the statements. During the 15-year period, 1953-1967, inflation averaged 2% per year. While the highest rate of inflation during the period was 3.7%, the effect on net income was much more severe. This is partly because net income is a small amount compared to other amounts on the financial statements. Secondly, restatement of items such as depreciation brings a cumulative compound effect on the statements.

Restated income of the 18 companies for the two years in the study ranged from an increase of 434% of historical income to a decrease of 31%. Gains and losses from holding monetary assets also varied widely.

The effective income tax rate varied in both directions. In some cases the restated rate was lower than the historical rate; however, in most cases the restated rate was higher than the historical rate. Cash dividends as a percent of net income acted in like fashion. In some cases the restated rate was lower than the historical rate; in twice as many cases it was lower.

The rate of return on owners' equity was not available for all firms. In those cases where it was available, in every instance the rate of return using restated figures was lower than the rate of return based on historical figures.

The author points out certain observations concerning the study. The companies which are most affected by the restatement process are:

1. Capital intensive companies,
2. Companies with expensive and slow-moving inventories,
3. Companies which are either heavy debtors or heavy creditors.

In connection with the third point, those companies which have large receivables lose because of general price level changes in inflation and companies with heavy debt gain. Of course, a company which is able to offset heavy receivables with heavy debt will offset gains and losses.

The most interesting statement in the article is that the companies involved reported that proper preparation in advance would have solved many practical problems which were encountered in the study. Also, restatement in the first year is most time-consuming because in subsequent years analyses prepared previously can be utilized. The participants in general agreed that with proper preparation practical problems should not present a significant barrier to preparation of general price level financial statements.

Thus, since it is clear that supplementary, price-level-adjusted financial statements offer useful information to those both inside and outside the firm, this reviewer believes we shall certainly see more of them in the future.

M.E.D.

"ACCOUNTING AND AUDITING FOR REGULATED INVESTMENT COMPANIES," Frank H. Tiedemann, CPA, THE JOURNAL OF ACCOUNTANCY, Volume 129, Number 1, January 1970.

In a clear, concise, and well organized manner, Mr. Frank H. Tiedemann, CPA, presents the fundamental aspects of accounting for regulated investment companies and, in particular, for the popular mutual fund.

The discussion, narrowed to manageable proportions, introduces the various types of investment companies, explains the applicable financial accounting and reporting requirements, and includes the germane income tax provisions. His coverage of the important compliance reporting to the SEC provides insight into the extent of government regulation of the required accounting and reporting practices. Drawing heavily from his extensive practical background in this specific accounting area, the author includes helpful information on the planning of special and supplementary audit procedures and on the writing of pertinent accountants' reports.

This article, as introductory reference material, is worthwhile reading for the accountant who is not involved in this accounting province. For those who are, it should serve as a quick reminder on important points and provide a framework upon which to build a course of concentrated study.

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THE TAX ADVISOR

Beginning January 1970, a new magazine appeared on accounting book shelves and desks. Published by the American Institute of CPAs, the announced purpose of the monthly publication is to keep the reader "reliably informed on federal tax matters." Written for the "sophisticated tax man" it will feature articles to give "greater insight into current problems" in an accurate, concise, and practical way. The "Tax Clinic," formerly found in THE JOURNAL OF ACCOUNTANCY, will be a regular feature, as will Tax Trends, Tax Practice Management, Estate Planning Techniques, Working With the IRS, and Washington Report. The charter issue contains a special supplement, a checklist-summary of the 1969 Tax Reform Act, prepared by the Chairman of the Executive Committee of AICPA's Division of Federal Taxation, William T. Barnes.

One of the special features of the new magazine is that three references (to the official reporters, Commerce Clearing House, and Prentice Hall) will be provided for all decisions except those of the Tax Court. The 64-page magazine will also contain a selection of each month's rulings and cases, together with comments from the editor as to whether "(1) a conclusion, ruling or decision is questionable, (2) tax planning opportunities are available, and (3) there are limitations or wider implications to a holding." (THE CPA, December 1969). Subscription price to non-members of AICPA is $25 per year.

M.E.D.

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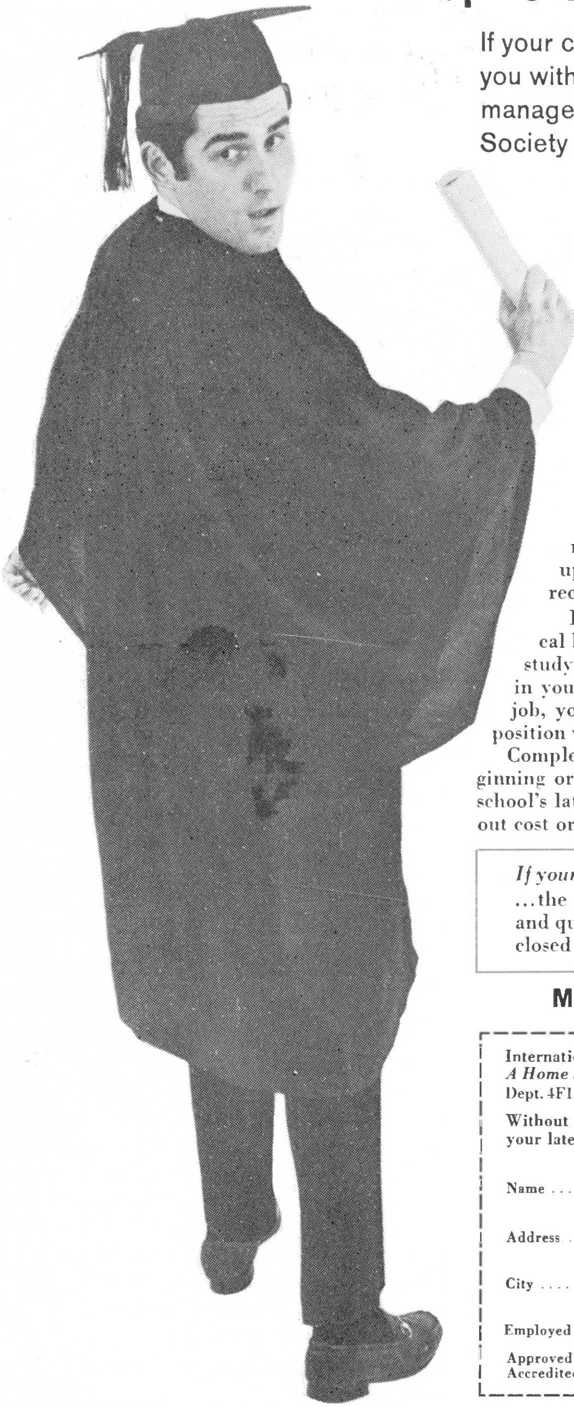

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