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Comparability Means To Have Like Things Reported Alike — Trueblood Commission Report

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Accountants have long stressed the importance of comparability. Six of the twelve objectives listed by the Study Group on the Objectives of Financial Statements (The Trueblood Commission Report) emphasizes that financial statements must be useful in the process of *predicting, comparing,* and *evaluating* future earnings and cash flows. Current published financial statements fall short in fulfilling these objectives. This column examines the 1974 financial statements of the big-four automobile manufacturers. Certain specific accounting practices and policies, all Generally Accepted Accounting Principles (GAAP), are compared. Comparability is weakened when practices vary significantly among companies in the same industry.

American Motors (AM) operates on a September 30 fiscal year, with Ford, Chrysler and General Motors (GM) reporting on the calendar year. Three different auditing firms audit the statements. All four companies received an unqualified report with the standard phrase that the statements "fairly present" in accordance with GAAP. Only instances where the practices are different are discussed, since reportingdifferences may result in incomparability.

Comparing financial statements without close examination of the footnotes results in an exercise in futility. In the footnotes are found much quantitative and qualitative data necessary to compare and evaluate statements. APB Opinion 22 issued in April, 1972, and effective for years beginning after December 31, 1971 requires disclosure of accounting policies and practices. Disclosure is required if a policy has been selected from alternatives, or unusual or innovative applications of GAAP have occurred. Opinion 22 resulted in more information being given in annual reports. (Incidentally, a committee of the AICPA and the New York Stock Exchange recommended such disclosure as early as the 1920s.) This additional disclosure enables the pinpointing of significant differences. Prior to 1972 often the only accounting policy disclosed was that of consolidation practices.

Objective No. 1 of the Trueblood report reads: "An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information." Using this as a criterion only the published financial statements were consulted for the remarks that follow. Considering myself a reasonably "informed reader," I found the statements deficient. The comparisons would have been easier had I used the 10K's. However, since so few stockholders request the 10K, it is safe to assume that the majority of investment decisions are made without the information contained therein.

Translation of foreign currency. All four companies have foreign subsidiaries. Since the FASB exposure draft on "Accounting for Translation of Foreign Currency Transactions" was issued on December 31, 1974, it could have had little or no influence on the statements under consideration. Translation policies established in ARB 43, Chapter 3A are being used. All except American Motors are translating all balance sheet items at rates in effect at the close of the period except plant and equipment. AM apparently translates long-term liabilities on the same basis as long-term assets.

Adjustments due to foreign exchange translations receive at least three treatments. Chrysler recognizes all gains and losses currently, Ford recognizes all normal gains and losses but establishes a reserve for abnormal items; GM takes losses in year of occurrence, but defers gains. AM states that such items are not significant and gives no indication of statement treatment. Are these amounts significant? An examination of statement footnotes gives some indication of size.

Ford states, "During the fourth quarter, a 34 million charge was made to the Reserve for Foreign Operations." This reserve is shown in a section of the balance sheet called "Other Liabilities and Reserves". The charge was principally for the "abnormal costs incurred during the year in Argentina, . . " This charge represented 9.4% of net income. Had it been charged against income, the earnings per share would have been $3.50.

General Motors has a "Reserve Applicable to Foreign Operations" of $142 million shown as an item under Deferred Credits and Reserves. The amount has not changed since its creation in 1954. However, GM charged 14.7 million in 1964 and 67 million in 1973, a total of 81.7 million, to an item called Other (principally deferred translation gains and intercompany profits), also shown under Deferred Credits and Reserves. This charge was made in spite of GM's statement "accumulated unrealized loss from translation of foreign currency accounts of any foreign subsidiary is charged to income and accumulated unrealized net gain is deferred." Are the amounts material? Judge for yourself.

Provision for pensions. All four companies report that current pension costs are accrued and funded. Past service costs are accrued and funded over a period of 30 years for all but AM who is funding over a period of forty years. These date are given under the Summary of Accounting Policies. A later footnote in each of the statements gives data that is very relevant for comparison purposes, namely, the amount of unfunded vested benefits at the close of the accounting period. AM reports that a deficit of approximately 80 million exists between vested and funded benefits; this compares to a 1974 charge to pensions of $24.7 million. For Ford the unfunded portion rises to $1,465 million vs. a current charge of $385 million. Chrysler reports a pension cost of $229 million vs. an unfunded amount of $1,201 million. GM, the giant of the industry, reports current costs of $819 million and $3.4 billion unfunded. The reader will recall that APB Opinion 8 does not require that the unfunded portion be reported as a liability on the Balance Sheet. Thus, all of the amounts listed as unfunded, but vested, are *unrecorded* liabilities.

Of interest is the fact that under UAW contracts signed in 1973, effective in 1974, annual pension costs would increase; but only Chrysler gave an estimate for such increase — $50 million. Actually, the increases were $100 million for GM, $54 million for Chrysler, $50 million for Ford, and $.15 million for AM. If Chrysler could give an estimate, which proved to be substantially accurate, why could not the other companies? None of the four warned the reader that the unfunded portion for the three largest companies would increase from 200 to 400%. Ford did warn its readers that the Amendments to the UAW Retirement fund would "provide for substantial benefit increases over six years that will increase pension costs and the value of vested benefits in each of the years," yet did not warn that the unfunded portions would show a dramatic increase. It is difficult to see how rational comparisons could have been made without more information. Unfunded vested amounts also increased because of the market decline of investments held by the pension fund trustees.

TABLE I

COMPARISON OF SELECTED FINANCIAL STATEMENT ITEMS

	American Motors	**Chrysler**	**Ford**	**General Motors**
Net income (millions)	28	(52)	361	950
Net assets (millions)	383	2,660	6,241	12,530
Earnings per share (dollars)	.94	(.92)	3.86	3.27
Dividends per share (dollars)	.20	1.40	3.20	3.40
Unfunded vested pensions (millions), 1974	80	1,201	1,465	3,400
(millions), 1973	80	563	620	800
as % of 1974 net assets	21%	45%	23%	27%
Goodwill amortization, pre 1970	—	—	—	10 yrs.
after 1970	40 yrs.	20 yrs.	—	10 yrs.
Foreign translation adjustments	loss as occurs	currently	normal currently, abnormal reserve	losses currently, gains deferred
Tax provision on undistributed earnings of subsidiaries	no provision	no provision	provision on expected div. dist.	provided
Investment tax credit	reduction of tax expense in year credit arises	amort. on life of asset	amort. on life of asset	amort. on life of asset

Ford and GM both state they expect no material changes in pension costs as a result of The Employee Retirement Income Security Act of 1974. When one compares the unfunded, vested portion shown in Table I with the net assets of the companies, it appears that Congress must have had some idea of the unfunded amounts when it provided that in the event of the dissolution of a plan, 30% of the net assets of the entity could be taken by the government to provide for such vested benefits.

Amortization of Goodwill. APB Opinion No. 17 states "The Board believes that the value of intangible assets . . . eventually disappears and that the recorded costs . . . should be amortized . . . The period of amortization should not, however, exceed forty years." The opinion was effective for all intangible assets acquired after October 31, 1970. GM is amortizing *all* goodwill over a ten year period. GM reported a charge of $6.4 million amortization in 1974 with a remaining asset balance of $32.5 million. Ford is taking *no goodwill amortization;* none has been acquired since 11-1-70. However, it has a total goodwill of $279 million vs. the GM total of $32.5 million. Chrysler reports no amortization for goodwill arising prior to 1970; subsequent acquisitions are amortized over 20 years. However, the amount amortized is not shown as a separate item on the income statement, but net of book value of goodwill decreased $.2 million during 1974. One may conclude that amortization was an insignificant amount. AM reports no amortization on pre-1970 goodwill, 40-year period on subsequent acquisitions. Total goodwill amortizations are not available. The ending balance in the goodwill account is $10 million. Auto companies are far from consistent in goodwill practices.

Depreciation. All four report depreciation on an accelerated basis. However, 42% of AM assets are on a straight-line basis. No rate is given, but GM and Ford state that their method results in a charge of approximately two-thirds of the total cost during the first-half of the estimated useful lives. GM does report a change in

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earnings or incur expenses will occur in the future and will be reflected on parent company records at translation rates existing then rather than at rates pertinent to the date when the asset was acquired.

Surely the accounting profession must recognize that to the best of our ability a fixed asset should reflect its future earning capacity. This is the foundation for the use of historical cost which implies that purchasers are willing to acquire an asset at a particular price because they believe its future earnings will justify the outlay. By using the proposed temporal translation method for fixed assets the FASB ignores the going-concern principle, one of the basic tenets of our profession. For the Board implies that these assets are readily convertible into currency by the parent company at their original cost, less depreciation. In reality, the going concern has no intention of repatriating these assets but rather intends that they continue to produce in the country of their locus.

Unfortunately, the temporal method is founded on the premise that GAAP is sacred and inviolable, a concept very far from the truth. The defense of the temporal method (par. 97-100) clearly exposes it as an accommodation to whatever current or future changes might occur in GAAP. But this timid approach does not generate a realistic means of reflecting relevant information.

We have somewhere along the way lost sight of the basic fact that a capital investment is not intended to be converted back into cash, regardless of the currency of the country in which it happens to be located. What will be realized in cash is the earnings generated by that investment over its useful life. Therefore, translation at an historical rate for fixed assets serves no useful purpose. In fact, it creates an illusion of value and, rather than being a conservative practice, overstates the asset's value when the foreign currency is devalued. In the above illustration, if the property had ceased to earn £ 10,000 per year, that would have been cause to reflect a reduction in annual earnings. But since the income remained as projected, the exchange loss should have been reported. The retention of historical value as a principle is applicable only so long as that historical value is expressed in the currency in which the asset is generating income. A discussion of this same principle where the foreign currency is revalued upward against the dollar is illustrated by Dr. Lee J. Seidler in his excellent article, "An Income Approach to the Translation of Foreign Currency Financial Statements," (The CPA Journal, January 1972, pp. 26-35).

The measure of a skilled, independent operator is the ability to exercise judgment. Even plumbers are permitted discretionary latitude in the exercise of their calling. Why then do we seek to deny professional accountants the right to exercise judgment which might be required under the situational approach? The publication of concise guidelines should provide sufficient control to assure the use of relevant translation procedures.

The objective of the FASB should not be to distort reality so that it will conform with GAAPs, but rather to adjust GAAPs so that they produce results more reflective of reality. For at the present time GAAPs are very suspect ensigns. They are not recognized as legally binding by the judiciary nor are their results respected by those who analyze our work. Let us recognize them for what they are — a collection of conventions and compromises — the very shaky foundation of a much criticized process of reporting. If we would improve our image and the confidence of our clientele in the strength of our profession then GAAP must be improved.

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method of classification of assets that reduced 1974 depreciation by $97 million, this represented 13% of the total charge for the period and approximately 10% of net income.

Tax Provision on Undistributed Earnings of Subsidiaries. Different policies for handling undistributed subsidiary earnings were reported. AM states that income taxes have not been provided on approximately $20 million of earnings permanently reinvested. Chrysler made almost the identical statement relative to $550 million subsidiary earnings. Ford makes provision for taxes payable on portion of retained earnings expected to be remitted as dividends, but states that no tax provision has been made for $1,225 million reinvested. GM makes provision for deferred taxes on unremitted earnings of foreign operations.

Other differences. Only AM treats the *investment tax credit* as a reduction of tax expense in the period the credit arises; others amortize over the life of the related asset. All reports are silent on the policies related to *product recall.* Ford has a footnote labeled *Litigation and Claims* which states in part "Various legal actions, . . . claims . . . class actions . . . are pending . . . which, if granted would require very large expenditures. . . . In the opinion of counsel for the Company, any resulting liability will not materially affect the consolidated financial position of the company." GM's section on *Contingent Liabilities* reads in part "There are various claims and pending actions . . . arising out of the conduct of the business. The amounts of the claims and actions . . . were not determinable but, in the opinion of the management, the ultimate results will not materially affect the consolidated statements . . ." Note that the GM footnote is based on the opinion of management. One wonders what the opinion of counsel was. Neither Chrysler nor AM mention any ligation or contingent liabilities.

Conclusion. The four financial statements are by no means comparable. Nor is sufficient information given to enable the reader to reconstruct the statements so that they could be compared with any degree of confidence. An exercise such as this further convinces me that additional rulings by professional accounting bodies merely make statements more confusing. Hopefully, some of the current FASB projects will eliminate some of the myriad of choices now available that enable managements to "manage income" by the choice of methods acceptable as GAAP.