1-1-1916

Accounting inconsistencies and fallacies, an address delivered before the 1916 Convention of the American Electric Railway Accountants' Association

Homer Adams Dunn

ACCOUNTING INCONSISTENCIES AND FALLACIES

AN ADDRESS DELIVERED
BEFORE THE 1916 CONVENTION
OF THE
AMERICAN ELECTRIC RAILWAY
ACCOUNTANTS' ASSOCIATION

BY
HOMER A. DUNN, C. P. A.,
MEMBER OF THE FIRM OF HASKINS & SELLS,
CERTIFIED PUBLIC ACOUNTANTS

Mr. President and Members of the Association:

More than the mere keeping of books and records, the science of accounting involves their designment to produce financial and operating data of practical usefulness and such arrangement thereof in statements as will best aid the exercise of judgment in two distinctly separate and somewhat opposed fields: (1) administration of the business; (2) investment in the securities of the business. Obviously both should be supplied with the truth so that neither may be misled, but through genius the truth may be illuminated. And here let me emphasize that Accounting may be brought to its highest state of efficiency only by adding genius to the other necessary qualifications. When genius is displayed in Accounting its recognition and substantial reward should be in quite as full measure as is accorded to it in the arts and sciences and in commerce and finance. Bear in mind, however, that genius is a laggard and remains in obscurity unless spurred on by industry.

Inconsistencies and Fallacies in Accounting are the results of indifference, vacillation, ignorance, expediency, casuistry, or dishonesty of purpose. Indifference, vacillation, or ignorance may produce either or both, but where expediency, casuistry, or dishonesty of purpose govern principle does not abide in accounting or other human activity and the inevitable result is fallacy.

Inasmuch as comparison is the measure of efficiency in human endeavor, conclusions drawn from comparisons will be fallacious if consistency is not maintained even to the highest refinements. Consistency cannot be maintained where indifference or ignorance prevail. Vacillation in policy respecting maintenance of property may produce inconsistencies unless there be accounting provisions against them. Such vacillation may run back and forth between two extremes, but, while it may not change the total maintenance expenditure in a given period of time, alert, competent, and scientific accounting may so keep the accounts in adjustment as to prevent distortion in graphic chart expression of their relations, if only it is given authority approximating that of the actuarial function in life insurance.

Inaccuracy or unreliability in accounting for the use or consumption of operating materials and supplies is not an unusual source of inconsistencies. As Accountants, you know that many who are charged with the function of management lay great stress upon integrity and accuracy in the handling of and accounting for cash, but fail to realize that consistent comparisons of operating costs are dependent upon the application of the same qualities to the handling and accounting for materials and supplies. It seems seldom to occur to them to place the accounting for materials and supplies under the jurisdiction of the officer charged with the general accounting function, even to the extent of supervision over the inventories.

As bearing upon the need for such supervision, I once came in contact with a very unusual situation—unusual because the developments were quite the opposite of the ordinary. Inconsistencies in comparisons brought about investigation and the development was that, because the company had been enjoying some unusual revenue prosperity, an operating officer, whose range of control was sufficient for the purpose, had conceived and carried into execution the idea of charging out more operating materials and supplies than were being used; not with dishonest intent but with the end in view of accumulating a secret reserve for use without effect on expenses when a recession in revenue might be experienced and there be greater watchfulness over the relation thereto of the operating costs.

I might cite numerous other causes for inconsistencies in accounting, even going into the higher refinements of comparisons, but the ramifications of the subject well may be left to your experience and intelligence.

The principle in accounting to which I made reference a few moments ago is the one defined in the Century Dictionary as

> "A truth which is evident and general;
> "a truth comprehending many subordinate
> "truths; a law on which others are
> "founded, or from which others are derived:
> "as, the principles of morality, of equity,
> "of government, etc. * * * * *".

Lexicons give the application of definitions to law, to engineering, to architecture, to chemistry, to medicine, to mathematics, and to society, but not to accounting. Some day, perhaps, a practical man will be drawn upon a lexicon review-board and recognition then will be given to accounting as one of the sciences. An accounting application of this definition should add to the first clause, "or which will stand the test of logic, as in accounting." This would give rise to question as to how to make the test. The best method I can suggest is to projectively widen the relations between quantities or factors and consider the result. A notable situation for illustrative purpose is the requirement in an accounting order of the Interstate Commerce Commission directed against steam roads that the balance of the Hire of Freight Cars account, arising solely from debits and credits for the interchange use of such equipment, shall not enter into the operating results of the respondent carrier but shall be treated as income derived from sources other than operations, in other words, shall not be included in or be set off against the operating revenue, according as the balance may run; and the further requirement that the respondent's entire cost of maintaining its freight cars (repairs, depreciation, and retirements) shall be charged to operating expenses. For a projective widening of relations, assume that a connecting railroad of one-hundred miles in length, that has been operated under the ownership of six-hundred freight cars, with a need for twice that number, and, under the condition of charging the hire of other carriers' freight cars to non-operating income, has been producing net operating revenue at the rate of $600,000.00 per annum; and that this railroad, discovering a large shortage of freight cars throughout the country and finding itself in an exceptional position therefor, acquires and places in service 10,000 additional freight cars. Inasmuch as the hire derived from these additional freight cars is required to be credited to non-operating income, and inasmuch as the normal cost of owners' repairs (distinguished from users' repairs under interchange rules), depreciation, and retirement is required to be charged to operating expenses and would amount to upwards of $600,000.00 per annum, you can see that the result would be to convert the previous net operating revenue into a net operating loss and that such a change would be wholly illogical in the light of the cause and conditions. If the Hire of Freight Cars account as set up were charged and credited per contra with the amounts necessary to make the operating expenses represent the true costs of *operating maintenance* for both the other carriers' freight cars and the respondent's own freight cars, there would be no difference in the net operating revenue whether the respondent owned 600 freight cars or 10,000 freight cars and, furthermore, the Hire of Freight Cars account would reflect a true non-operating income. It is by such projections that tests of principle may be made and fallacies be avoided.

I have wondered why the Interstate Commerce Commission, in its 1914 Accounting Order against Electric Railways, substituted "Corporate Surplus" for Profit & Loss Surplus," and made a sub-division into five primary accounts, viz.:

No. 447—Additions to Property Through Surplus,
No. 448—Funded Debt Retired Through Surplus,
No. 449—Sinking Fund Reserves,
No. 450—Miscellaneous Fund Reserves,
No. 451—Profit & Loss—Balance,

unless it were to lead the electric railway companies into definite appropriations to accounts 447 to 450, to be later closed by legislative prohibition against any use of the credit balances therein for dividend purposes or to be held subject to the Commission's permission of transfers back to Profit & Loss account. Whether or not a Profit & Loss surplus is available for distribution depends upon the cash position; certainly not upon acts of appropriation. The fact that these appropriation accounts were not made mandatory stands as evidence that the

Interstate Commerce Commission did not believe that it could enforce them.

Let us apply the projective test for the purpose of ascertaining whether or not there is anything fallacious in this plan of appropriation accounts with apparent intent to limit dividend distributions to the resultant Profit & Loss balance. Inasmuch as it appears that the Sinking Fund Reserves are but intermediary to the Funded Debt Retired Through Surplus, we may assume for the purpose that the entire funded debt has been retired and that the Sinking Fund Reserves have been closed; assume also that the original issue of the funded debt exceeded the tangible value of the property, i.e., covered a part of its franchise value, and that upon the last redemption and retirement of the funded debt the franchise value had been entirely amortized; assume also that throughout the period of the redemption and retirement of the funded debt and the amortization of the franchise value large expenditures were made for additions to property and that amounts equal to those expenditures were transferred by appropriation from Profit & Loss account to Additions to Property Through Surplus; assume further that as a result of these appropriation transfers and amortization charges there is a debit balance or deficit in the Profit & Loss account. It is too obvious to be gainsaid that since the amortization of the franchise value took nothing from the Company's treasury, there should be a substantial amount available for dividend distribution. The fact that, in the face of such a condition, there is a debit balance, or deficit, in the Profit & Loss account exposes the fallacy of this appropriation scheme.

Apparently there did not occur to the Interstate Commerce Commission the practical proposition of setting up a group of accounts as Common Shareholders' Accounts and consisting of

Common Capital Stock Outstanding,

Common Capital Stock Conversion Obligation,

Common Capital Stock Premium or Discount,

Governmental Grants in Aid of Construction,

Profit & Loss Surplus,

the total of which would represent the capital interest of such shareholders in the business as though collectively they were an individual and sole proprietor.

Some of you represent companies which are engaged in interstate traffic and, therefore, are amenable to the accounting orders of the Interstate Commerce Commission. Others of you represent companies engaged only in intrastate traffic, but in states where the Public Service or Utility Commissions have adopted the accounting order of the Interstate Commerce Commission directed to Electric Railways. In the interest of the shareholders of the companies so affected, and of the other companies whom you represent, I send by you a message to your executives and directors to beware of appropriation accounts and acts of appropriation; that they should be shunned as fallacious and dangerous.

That the surplus of a corporation is the excess of its assets over the sum of its liabilities and capitalization has been accepted and recognized as a fact for as long as corporate organization and accounting have existed; and it is immaterial whether the account representing this excess is entitled "Profit & Loss Account" or "Surplus Account." Whichever it may be, it needs no sub-division in its finality. The only purpose of preceding either with the primary accounts of revenue, expense, and income is to have ready at hand, in accounts, the data necessary for determining the causes of gains or losses, thereby avoiding for such purpose recourse to the analysis of a sole account, the former method being more accurate and economical than the latter.

As illustrating the lack of accounting harmony existing as between the Federal Interstate Commerce Commission and the State Public Service or Utilities Commissions, and as between many of the latter, the full correction of which never will be realized excepting through a greater nationalism in our political organization, it is noticeable that in the accounting order of the Public Utilities Commission of Ohio, directed to electric utilities, there is a grouping of accounts under the general title "Proprietary Interests, Reserves and Profit & Loss Account." This accounting order does not require or make provision for appropriation accounts other than one for miscellaneous appropriations which are specified as optional appropriations from surplus for gratuities, gifts, and reserves. While this order provides an Income and Profit & Loss account for the current period, it is further noticeable, however, that this is a temporary account to be closed into the final Balance Sheet account designated as "Surplus" or "Deficit," according as the balance may run. The Wisconsin Commission saves itself from like criticisms by the *omission* of Profit & Loss account from its accounting orders.

There is similarity between the Federal Commission and the Ohio Commission and several others in respect of Sinking

Fund Reserves, and this is one of the greatest fallacies to be found in Commission accounting orders. This occasion does not warrant the time necessary to an adequate discussion of the subject. Instead, I will call your attention to an article by my esteemed partner, Mr. Charles S. Ludlam, which appeared in the March, 1914, issue of the Journal of Accountancy, under the title "Treatment of Sinking Funds," and in which I believe he makes very clear the fallacy of the Sinking Fund Reserve. To those of you who may desire it, I shall be glad to send a reprint of Mr. Ludlam's article. Obviously if a Sinking Fund Reserve is fallacious, the accounting orders of some of the Commissions which provide that the increment to the Sinking Fund shall not go into the corporation's Income account are equally fallacious and violative of principle.

I cannot leave the Interstate Commerce Commission without calling attention to an absurd inconsistency which has been copied by some State Commissions in respect of the amortization of funded debt discount and expense. The requirement is that the Income account for this amortization shall be charged during each fiscal period with the proportion of the discount and expense applicable to that period and that this proportion shall be determined according to a rule, the uniform application of which throughout the interval between the date of sale and the date of maturity will extinguish the discount and expense; that the charge to this account for any period shall not be either greater or less than the proportion applicable to that period, so long as any portion of the discount and expense remains unextinguished; and that the accounting company may, at its option, charge to Profit & Loss account all or any portion of the discount and expense on funded debt remaining at any time unextinguished.

Can you conceive of anything more illogical than that the Income account may be wholly relieved of charges for the amortization of funded debt discount and expense but may not be partially relieved therefrom by write-off to Profit & Loss of a portion of the discount and expense and amortization of the remainder throughout the interval between such write-off and the maturity of the debt. I do not believe in the write-off to Profit & Loss of any part of funded debt discount and expense, because I cannot clear from my mind the fact that it is just as much a part of the cost of using borrowed money as contractual interest, and because it should not be omitted from the net income to be considered in rate cases, nor omitted from the net income subject to the federal income tax.

Lack of coördination is next door to inconsistency, and of this many of the State Commissions are guilty in their provision of administrative accounts. In respect of gas companies, they do not anywhere arrive at the gain or loss arising from the production, sale, and distribution of gas, because they do not coördinate the gas revenue and the entire cost of its procurement. The Wisconsin Commission includes earnings from residuals and miscellaneous earnings from operations in operating revenues, and then follows with a number of non-operating revenues before arriving at the total revenue, against which it sets off the total operating expenses in primary account detail. It seems entirely to lose sight of the fact that the principal business of a gas company is to produce, sell, and distribute gas, in that it does not provide that the selling value of residuals and by-products, less labor, material, and overhead cost of conversion of residuals into by-products, should be credited to the cost of producing gas, and so does not arrive at a base for cubical quantity cost comparisons. Furthermore, it seems to lose sight of the fact that merchandising and plumbing are promotion features of the gas business, and that any so-called profit derived from these activities, which is determined without their being made to bear their proper proportion of the general overhead expenses, should be applied, together with the miscellaneous earnings, to the reduction of the total of such expenses, so that when the total of all expenses is deducted from the total of the gas revenues the resultant remainder may be the net revenue derived from gas operations. Since the promulgation of its 1908 order, the New York State Second District Commission has tried to make some improvement in the accounting in respect of residuals and by-products, but without much success, for it includes in the Miscellaneous Revenues the proceeds derived from residuals and by-products, but it makes provision for crediting Direct Operating Expenses and charging General and Miscellaneous Operating Expenses with residuals produced "at a fairly estimated cost of manufacture * * * determined upon a consideration of average selling price less expense involved in preparing for market, selling, and delivery; that residuals put in store should be charged to Materials and Supplies at such estimated cost, and, when sold, should be charged over to Cost of Manufacturing Residuals Sold in General and Miscellaneous Operating Expenses." Of course, it would be too much to expect that it could conceive the practical proposition of carrying to the credit of Production Cost the net proceeds derived from the treatment or conversion and marketing of residuals and by-products plus or minus the increase or decrease in the inventory thereof.

I will not burden you with a considerable number of such instances but will give you the tenor of two recent rulings by different commissions. In sustaining an application for validation of bonds to be issued and sold under a mortgage the counsel for a company included, in addition to property expenditures, a considerable amount of discount on bonds previously validated under the same mortgage. The Commission accepted the tendered explanation of reimbursement for such discount and validated bonds to the amount of the application. Awakening later to the fact that they had validated an over-issue of bonds, by reason of the inclusion and their acceptance of the item of discount, an order was issued requiring that, prorated over a period of six years, the company should write out of its Road and Equipment account and charge Profit & Loss account the amount of the discount item; and this was done in total disregard of the fact that the discount in question had not been charged to the Road and Equipment account but, on the contrary, had been written off against Profit & Loss account prior to the application for validation. Apparently it did not occur to the Commission that it was improper to so write down the Road and Equipment account and that the proper remedy would be to correspondingly reduce the validation of bonds upon the occasion of another application which the conditions made altogether probable.

The other ruling was made to sustain the text of the Commission's accounting order and was to the effect that while interest maturing on the day next succeeding the date of the Balance Sheet should be included in current liabilities as interest matured and unpaid, the amount of bonds maturing on the same date, and to which the interest attached, should not be included in current liabilities but should be included in funded debt unmatured.

Lest you form the impression that I am against Commission accounting orders from all angles, let me say that such is not the case and that I believe they contain much that is good. I am in the same attitude toward such orders as was the late Robert G. Ingersoll toward a certain Church when he said: "I do not hate its members but do hate its creed." In relation to Commission orders I would substitute disagree for hate and inconsistencies and fallacies for creed.

If one is needed, my reason for not having confined this discourse to electric railway accounting is that I have felt sure of your interest in departures from principle wherever they may be found.