Journal of Accountancy

Volume 62 | Issue 2 Article 2

8-1936

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It is human nature to overstate one's assets and profits and to understate one's liabilities and losses. Taxing authorities do not believe this, but it is true. It results in paying too much rather than too little in taxes.

The "new dealers" believe that Santa Claus will pay the billions of dollars squandered in increasing production in one part of the country and decreasing it in another and in ruining our export trade.

Business men know that the president's new philosophy, no matter how artfully presented, will not prevent more and heavier taxes which must be paid in cash.

The proposal to tax all undistributed earnings has been fully discussed. It has nothing to recommend it. It is wholly unsound, complicated and unnecessary. It strikes at the medium sized concern and favors the large corporations. It is a significant phase of the "new deal" philosophy, which by any means whatever seeks to take from the man who has and gives to the man who has not.

It flies in the face of all human experience. Thrift becomes an obsolete word. Self reliance is forgotten.

Spending other people's money becomes so fascinating a pastime that the "new dealers" pass on from spending our money to tell us how to spend our time, what to read and what to think. I do not like this atmosphere.

In referring to all undistributed corporate earnings as avoiding taxes, the treasury insults our intelligence. In the first place all such earnings have been heavily taxed. In the second place most of the undistributed earnings are tied up in inventories, plant, etc., the greater part of the cost of which has been paid to labor. Calling names and accusing all men in business of not paying their share of the cost of government may win one or two elections, but in the long run the truth will prevail.

A great deal of criticism was directed against the house bill because corporations which paid dividends to avoid the penalty

* An address before the American Management Association, Newport, June 4, 1936.

tax upon undistributed income would find it difficult to persuade their stockholders to recontribute the money as new capital. It was suggested that by availing themselves of the principle of the United States supreme court decision 774, of May 18, 1936, *Koshland* vs. *Commissioner*, corporations could meet this problem by distributing all their income in such a manner that stockholders would be taxed and yet the corporations would not distribute funds, namely, by declaring dividends in common stock on preferred stock, or vice versa.

This may be all right from the corporation point of view, but is rather rough on the stockholders to make them pay a tax in cash when they receive no cash from dividends. If a taxpayer's entire income were from such paper dividends it would be a real problem.

It was rather amusing to see how quick the treasury was to claim it had this plan in mind all along. So far as I know, however, it had not previously mentioned it.

The fact is that the taxes now being sought are to pay for the frightful mistakes of the money spenders who, having had no experience in earning money, do not know how to spend it.

Most taxpayers pay too much in taxes rather than too little. The law is so complicated that it requires an expert to interpret it.

Even the experts do not pretend to understand it. In consequence most taxpayers decide doubtful points against themselves and are in ignorance of many of their rights. I tested this last winter in Florida. A hurricane destroyed much property which was not insured. The law permits a deduction for all losses arising from casualties. I asked about a dozen men—large taxpayers and heavy losers—if they had claimed the deduction. Almost all said: "No, they did not know they were entitled to it."

I do not feel competent at this time to discuss the effect on business of social security taxes. If "social security" means that a considerable part of the population from now on will expect the other part (including farmers) to support them in their old age, and if the effect will or may be a lessening of the old fashioned ideas of taking care of one's self and those directly dependent on the head of a family, then it is too much like Russia for me.

It means federal government participation in the family and social affairs of those who receive and those who pay.

Inasmuch as each community must pay in taxes according to ability to pay, why send the money to Washington to be filtered through a thousand hands and a score of agencies and come back to the community diminished so much that new taxes must be levied and so on. In other words the chief industry of the country will be the collection and dissipation of taxes. But if you kill the geese, who will lay the eggs?

Business men had better settle down to a little serious thinking about their accounting methods. Is it possible that profits are being overstated? If so, unnecessary and burdensome taxes are being paid on something which is not subject to tax under sound methods of accounting.

Contrary to general belief, congress has power to tax net income, but not unless it is realized or realizable beyond any reasonable doubt. The unsound and unfair provisions in the existing federal income-tax law which taxes gross rather than net income probably are unconstitutional. It is a disgrace that we have such a law, but business men are funny about such things and pay rather than fight.

It is important for every corporation of any size or with ramified business operations to consider its corporate structure and manner of operation and the probable effect thereon of the ever increasing federal taxes. In some cases, corporations may find it advisable to take immediate action, especially those corporations which have fiscal years commencing in 1935 which are not yet ended. They may be in a position to help solve their own problems by intercorporate dividends before the new procedure goes into effect.

There seem to be at least four factors which, in general, an economic business unit may do well to consider in the simplification of its structure and its operation with fewer corporate entities or even as a single operating company. These factors follow:

1. With increase in the normal tax rate, it becomes increasingly important to avoid situations where excessive taxes are paid as a result of unevenly distributed earnings within a group, as, for example, where some corporations have profits and others have losses.

2. The cost of intercorporate dividends makes it advisable to avoid situations when such dividends become necessary;

3. A penalty tax upon undistributed earnings makes it advisable to have fewer companies which have to be considered in meeting this situation;

4. The difficulty of guessing correctly for capital stock values when there is a great number of companies, and also where the amount of intercompany dividends to be included in income is

uncertain, and there is a danger of running into excess-profit taxes.

If it be granted that simplification of corporate structures is, in many cases, advisable, the problem of the means of bringing about such simplification presents itself. There are at least two main procedures, with, of course, numerous combinations and complications.

The first is to liquidate some subsidiaries. This procedure brings its own problems as to gains or losses on liquidation. In some cases I believe it will be found that liquidations can be used advantageously because losses from the liquidation of some companies can be offset by the profits from liquidation of other companies. One point especially worthy of consideration is where a loss on liquidation can be taken in full, or nearly so (that is, not subject to the $2,000 capital loss limitation), because the loss may be primarily a loss of an account receivable represented by advances to a subsidiary rather than loss on stock investments.

It is important to consider whether the factor of goodwill has to be taken into account in any particular case.

The second procedure is along the lines of a merger—either a merger of several subsidiaries into one subsidiary, a merger of subsidiaries into the parent company, or perhaps even the parent company into a subsidiary, or the merger of perhaps both parent and subsidiaries into a new company, which will be the sole operating company. The variations and problems are numerous and important.

The effect upon state taxes is an important consideration. In some cases at least the effect upon New York franchise taxes may be favorable, especially now that the state has adopted the procedure of excluding intercorporate interest, in many cases, from expenses. When there are several companies which become merged so that they operate as a single corporation, it is important to determine what methods can be adopted for conserving trade names, where they are important from the goodwill viewpoint. It is also necessary to determine some procedure for maintaining inactive corporations to prevent their names from being taken up by other companies.

The term "good accounting practice" relates to accounts and methods of accounting which fairly and adequately reflect the financial position of a concern and its gross and net income. When expenses are incurred and benefits are received in a given accounting period, good accounting practice demands that related liabilities be set up in the same period—as actual liabilities, if the amounts have been determined definitely, or in the form of estimated accruals or provisions if the exact amount of the liability is unknown. Likewise, when items of income arise or are collected in one period, and part of the income belongs to another period, good accounting practice requires that accrued or deferred accounts be set up so that the first period may not have the benefit of unrealized income.

Good accounting practice requires that current gross income be reduced by provisions for contingencies which can be determined within reasonable limits. This, however, is conservative accounting as distinguished from legal accounting. When items which have never been included in gross income or have been charged off as bad are collected, they are, from a legal and often from a tax point of view, considered income of the year of realization. The courts carry this theory to an extreme not warranted by business practice.

Good accounting practice requires that there be taken up as accrued income that which is substantially the equivalent of cash. Accounts and notes receivable due from and recognized by solvent debtors are deemed to be the equivalent of cash. Only in exceptional cases would the inclusion of accruals of uncertain or indeterminate items be sanctioned by good accounting practice. The definitions of income in the income-tax law and regulations are strictly limited by decisions of the United States supreme court. These decisions do not require the payment of tax on transactions which are not considered the equivalent of cash. Any treasury regulation which attempts to set aside this theory is not sound. But this must not be confused with commercial and accounting procedure.

Possibly the increasing burden of taxation will bring about a change in this strange acquiescence. I hope so. It may be that the enumeration of a few desirable changes in business methods will serve to prevent the payment of excessive taxes.

The denial of the right to carry business losses forward to succeeding years illustrates the unfairness of the existing law. No one but a congressman would base a tax on a business cycle of one year. Congressmen are paid by the month. If we don't look out, we shall have a new law taxing business profits by the month. With no carry over and with inevitable losses in some months, the tax on the profitable months should yield enough additional revenue to pay for three more dams or the silly Florida canal.

Seriously, more attention should be paid to the one-year income account. There are several important items which involve opinion rather than fact. In the past business men have more often resolved these matters of opinion in favor of the government and higher taxes than in favor of conservatism and lower taxes.

Taxpayers should maintain records to identify securities purchased at different times and at different prices, so that sales may be made of identified securities and the maximum tax benefit may be secured.

The elimination of consolidated returns created many new problems which were made even more serious by the tax on inter-company dividends, that tax may now be increased. Affiliated groups will have to watch constantly their intercompany accounting methods in order to determine properly the income of the separate corporations. Taxpayers are entirely justified in taking every legal means to avoid a situation where some of the affiliated corporations have losses and others profits, or where some of the corporations are subject to excess-profits taxes and others are not.

If the taxes on inter-company dividends are increased, it will be even more important to eliminate as many subsidiaries as possible. The problem of eliminating subsidiaries without incurring substantial tax liability is in many cases a most difficult one and in the past year or two has occupied an inordinate amount of the time of business executives, lawyers and accountants.

State taxes are becoming of increasing importance, and are often affected by accounting methods. For example, corporations may be subjected to unnecessary state taxes because they carry intangibles on their balance-sheets, or because valuation reserves are shown on the liability side of the balance-sheet instead of being deducted from the assets.

There are several factors that make the allocation of income and deductions between periods of the greatest importance. Income may be subject to excess-profits tax if accounted for in one period, though it might not be subject to excess-profits tax if accounted for in another period. The allocation of deductions may have a similar effect. If a tax is imposed upon undistributed income the rate of tax may vary greatly between years, depending on the portion of the income distributed each year.

A taxpayer handling long-term contracts and keeping its accounts on the completed contract basis may find itself subject to excess-profits tax in the year in which the contracts are completed, whereas if the accounting were on the percentage-of-completion basis no excess-profits tax might be payable, or the completed contract basis might result in losses in some years and profits in others.

The accrual of all items of taxes and other expenses in the proper year is important because taxpayers frequently find that they secure no benefit whatever for a deduction because the treasury holds that the deduction should have been accrued in an earlier year and the statute of limitations prevents a refund. The same principle applies to deductions for worthless securities, bad debts, plant abandonments, etc. All such losses should be charged off in the earliest possible year, for the taxpayer's protection. If a bad debt is charged off in one year and is held to have been ascertained as worthless in a later year, the taxpayer is entitled to the deduction in the later year. If the bad debt is charged off in one year and is held to have been ascertained as worthless in an earlier year the taxpayer does not secure the benefit of the deduction in any year.

One serious obstacle to a correct determination of taxable income is the selection of the wrong time of the year to make up the accounts. In many industries inventories are so much of a factor that the variation of a rather small percentage in valuation marks the entire difference between a profit or a loss for the year. If the inventory is overvalued and a profit is shown, taxes at present and constantly increasing rates may be ruinous. Even if the market starts to decline the day after the inventory has been valued, the over-payment of tax can never be recovered, if a net loss is incurred in the next year.

Adherence to one fiscal year, when efficiency and economy clearly require adoption of another, is inconsistent with sound business management. For every business enterprise there is a natural business year which should be adopted as its fiscal year.

The natural business year for a particular enterprise is the period of twelve consecutive months which coincides with the annual cycle of operations of the enterprise. Generally the natural business year will end when the business activities of the enterprise are at their lowest point in the annual cycle and when inventories, receivables and liabilities are reduced to their annual minimum. The natural year-end usually occurs just before the beginning of heavy inventory replenishment in preparation for a new season. Frequently all of the members of a particular industry are affected in the same way by seasonal conditions which would make it advantageous for them to adopt a uniform fiscal year.

Those responsible for the success of business enterprises should determine what is the natural business year for their industry and take steps to bring about its adoption by their own concern.

Advantages to Management

Some of the advantages to business management of adoption of a natural business year are as follows:

Inventories.—Inventories taken at the close of a natural business year:

(a) Can be taken with least interference with productive activities.

(b) Can be taken with greater ease since at the end of a natural business year the quantity of goods on hand will be lowest and inventory taking will thus be simplified.

(c) Involve less expense since members of the office force are free to assist, thereby eliminating need for temporary assistants.

(d) Reveal true valuations since market prices are more easily determined.

Closings and statements.—Clearly books can be more advantageously closed on the last day of a natural business year, while financial statements based thereon are far more informative than those which reveal conditions in the midst of a period of activities because:

(a) They reflect the outcome of a complete cycle of operations.

(b) They more accurately show the results achieved by commodity sales and policies initiated at the beginning of the period.

(c) The items in the statements can be more quickly, completely and accurately determined because of the more efficient inventory-taking and because receivables and liabilities are at a minimum.

(d) Such statements will show greatest normal liquidity attainable and hence serve better for accurate credit ratings.

Audits.—Since the general adoption of the natural business year will spread dates of financial statements through every month of the year instead of crowding them into the first three months, it is evident that certified public accountants can give more individual attention to the problems of each client.

Credit determination.—What is true of audits of natural-business-year statements by accountants is equally true of the analyses thereof made by credit departments of financial institutions as well as by the staffs of credit investigating and reporting agencies. They, too, can produce more accurate data concerning those who seek credit for the information of those who grant it if they can base their decisions on more timely and deliberate studies of natural-business-year statements which tell correct rather than badly timed and distorted stories of the conditions of a business.

Guiding policies.—The experiences of a past fiscal year are the basis of determination of policies and practices to be followed during the next fiscal year. Such prudent review and planning are greatly aided by the use of the natural business year, because:

(a) There is more free time for the purpose.

(b) Inventories, statements, and reports of auditors, being based on the proper close of a cycle of operations, make possible statistical data of far greater value to management than those based on an unnatural or improper business year.

(c) Accountants, under less pressure in making audits, will have better opportunity to serve clients and be helpful with guiding advice.

(d) The banker with the complete and accurate picture of a natural business year before him can be more deliberate in dealing with credit requests with resulting benefit to the borrower.

(e) A combination of all these factors facilitates and makes far sounder the preparation and adoption of a budget and work program for a new natural business year.

Social Security Promoted

Wide-spread adoption of the natural business year—which will mean numerous changes from December thirty-first closings and statements—will be of particular importance and value to employees of accounting firms, credit departments of financial and commercial institutions, credit investigating and reporting agencies and to the employees of the bookkeeping and accounting departments of the businesses themselves. They are thousands in number.

For them the general adoption of the natural business year will bring relief from feverish activity and long hours of overtime which now occur during the early months of the year. As a result their employment and earnings will be more regular and stable, thereby helping to promote social security and general welfare.

Concerns which have never given the matter much thought should now consider the desirability of changing their fiscal years to correspond with minimum inventories and maximum opportunity to close the accounts on a basis which in no circumstances will permit the overstatement of profits and the consequent overpayment of taxes.

There is rather widespread misunderstanding of the rule "the lower of cost or market" as applied to inventory valuations. The principal reason for the rule is the anticipation of losses, and, to some degree, the use of prices which will yield a profit upon realization.

I am very strongly of the opinion that the word "market" means the lower of the price at which an article can be repurchased, replaced or reproduced and the selling price less certain expenses and (perhaps) allowance for profit. I understand that many published statements contain a description of inventory pricing as "lower of cost or market" when, in fact, the inventory could be replaced for an amount less than the balance-sheet figure. Some accountants and some business men follow the theory that as long as the inventory is raw material, the phrase "lower of cost or market" means the lower of cost or repurchase price, but that as soon as the inventory is in process or is finished, the phrase means the lower of cost or selling price less the amount of certain expenses or allowances. I think it would be a forward step if there should be general acceptance of the principle that no item in the inventory should be priced at a figure higher than the lowest of (a) cost, (b) replacement market or (c) selling price, less applicable expenses.

When applied to inventories of goods for sale in regular course, "market price" usually refers to the replacement cost, assuming that it would be wise to replace the identical goods in the same quantities. "Market price" also means the amount of net proceeds which can be readily realized from the sales in regular course. It is assumed that the entire profit will be credited to the period of delivery and that the current period will absorb any loss incident to the "markdown" of actual cost to replacement cost or net realizable value, but it is not necessary to increase the loss in the current period so that the succeeding period may show a profit. The term "net proceeds of sale" implies that all direct selling and delivering expenses but not general administrative overhead have been deducted.

In dealing with goods which have declined in value "market price" need not be a price which will yield the full normal profit. It is, however, sound and conservative practice to mark down unmarketable goods to a point at which there will be no possible loss in a succeeding period.

A definition promulgated by the treasury is almost ideal: "Under ordinary circumstances and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer." Art. 22 (c)–4 Reg. 86.

The principle is followed in theory, but in practice the most vital and controling element in the definition, viz., "in the volume in which ordinarily purchased," is ignored. In a seller's market large purchases result in an advance in the bid prices; in a buyer's market large sales result in a decrease in the bid prices. Most people who intelligently analyze balance-sheets are interested in large quantities and in the influence of large quantities on the market. Fluctuations affect small concerns and large concerns alike, except when a small concern fills its requirements or sells its products in a market in which the larger concerns in the same industry do not participate. These cases are rare, because large concerns do not stay out of the market very long and small concerns can not, as a rule, choose their own times to trade.

In certain industries adoption of the principle of a base price for so-called permanent stocks has gained some headway in recognition of the fact that a business cycle is not one year. In times of falling prices or depression, losses are first sustained on the realization of inventories carried at prices which then appear too high. Such losses could be minimized if there were general acceptance of the permanent stock principle. It is hard to conceive any basis of accounting which will give an exact measure of the net income for a period of one year. The permanent-stock principle would have the virtue of minimizing profits on a rising market and minimizing losses on a falling market.

In many industries substantially the same result as that contemplated by the permanent-stock principle could be accomplished by using the "last in, first out" method of costing sales and inventories instead of the "first in, first out" method. The advantages of the former method have been studied by the American Petroleum Institute and numbers of the large oil companies are, I understand, now using it.

Some taxpayers may secure a larger aggregate deduction if plant ledgers are maintained and depreciation is computed on separate units rather than on a composite basis. Furthermore, in ordinary circumstances the treasury is not allowing losses on discarded machinery and equipment where a composite rate of depreciation is used.

Other items which depend on opinion (as fact is not ascertainable) are depreciation and obsolescence. It is true that many concerns claimed and obtained greater allowances for these items than was justified by subsequent history, and in such cases the treasury properly required that the rates be adjusted. But in a vast number of cases at the present time the allowances for depreciation and obsolescence are insufficient and should be increased.

Now as never before every item on the asset side of the balance-sheet should be scrutinized and if, at the end of the next closing period, the book value of any asset can not honestly be carried over to the next fiscal period at such book value, then by all means write the item down or off. Otherwise you may be paying an unnecessary tax.

I do not know enough about the operating details of business to suggest the possibility of decreasing the aggregate of accounts receivable by more expeditious collections and the reduction in inventories by more rapid turnovers, and thus make possible the distribution of enough of the year's profits to escape a tax on undistributed profits. I do know that my firm's comparisons of the balance-sheets of concerns in each branch of business show that some collect better than others from the same customers and that some have less money than others tied up in inventories, in relation to the total business done. Everyone knows this to be true, but many do nothing about it. Before joining in the cry that the tax on undistributed profits will ruin your business because of inventories, accounts receivable and plant extensions, check and double check those three items and be sure they correspond favorably with your most efficient competitor.

It will annoy you considerably if the tax on undistributed profits ruins you and does not ruin others in the same business as yourself.