Journal of Accountancy

Volume 28 | Issue 1 Article 1

7-1919

Influence of the War on Balance-sheets

Robert H. Montgomery

The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 28 | JULY, 1919 | No. 1

Influence of the War on Balance-sheets*

By ROBERT H. MONTGOMERY

Most balance-sheets of recent date differ radically from those published prior to the commencement of the world war. Changes worthy of comment appear not only in the surplus account but particularly in such items as plant, inventories and reserves. Many of the dubious items on the asset side, such as deferred charges and capitalized expenditures of doubtful permanent value, have disappeared. Will this desirable state of affairs continue?

The noticeable change in balance-sheets due to war conditions commenced in 1916. At the end of 1914 depression was quite general, values were down, federal tax rates were low and there was little inclination on the part of business men to make any changes in their balance-sheets other than those which had periodically been made during prior years.

At the end of the year 1915 no substantial change had taken place. There had, however, been some recovery in business and large orders were being placed for war purchases, chiefly emanating from foreign governments. Federal tax rates continued low.

Throughout 1916 business continued to improve and with the enactment of the federal revenue law of September 8, 1916, effective as of January 1, 1916, which carried with it increased federal taxes, business men commenced to scrutinize their balance-sheets with an interest which had no precedent and was unique in thoroughness.

On March 3, 1917, the first federal excess profits tax law was passed. Consequently from the beginning of the year 1917 the majority of business men have constantly had in mind the effect

* An address delivered at the annual convention of the New York State Bankers' Association at Albany, New York, June 12, 1919.

of federal taxes on profits. As almost every item of a balance-sheet affects directly or indirectly the computation of taxes, it is obvious that the greatest single influence which has ever been felt on balance-sheets is the federal excess or war profits tax.

Generally speaking, balance-sheets are accurate when tax rates are high and profits are substantial. It cannot be said that the average balance-sheet is accurate when tax rates are low or when tax rates are high and profits are not substantial. I am referring now to the balance-sheet as it is made up without supervision or certification from an outside source. The tendency to fool one's self has been so strong and so general that the ordinary balance-sheet in the pre-war period, when subjected to investigation by a disinterested third person, required drastic treatment.

Except in the comparatively few cases where special reasons existed for understating values or understating profits, most business men were unwilling to provide sufficient depreciation; they were unwilling to cut down inventory values; and they were reluctant to provide sufficient reserves against accounts receivable. They insisted on carrying "souvenirs" as perfectly good assets, and they borrowed large sums of money on the strength of such souvenirs. This tendency was so general that most bankers in scrutinizing balance-sheets mentally calculated additional reserves against the assets mentioned. The result was that the conservative business man who had provided sufficient reserves suffered the penalty of having, in effect, his actual quick assets reduced because the non-conservative man had neglected to provide sufficient reserves.

The attitude of the treasury department in the matter of federal taxation during the years 1909 to 1917 was not helpful from the point of view of conservative balance-sheets. The agents of the department were constantly disallowing depreciation and amortization charges; allowances for obsolescence were stricken out, and, in general, business men were encouraged to carry their assets on their books at inflated values.

Bankers' insistence upon accurate balance-sheets, supplemented by the action of another governmental agency, viz., the federal reserve board, offset the influence of the treasury department and worked for a constantly increasing improvement in the trustworthiness of balance-sheets. Progress, however, was fairly slow until in the year 1917, with its enormous federal taxes, there was brought about what might be called a revolution in balance-sheets. For many years bankers and accountants had spent a vast amount of time in analyzing balance-sheets. Item after item on the assets side was dissected and inquiries were made as to the actual worth of book figures. The liability side was given less attention, but there was the constant fear that all liabilities were not shown.

At the end of the year 1917, without the intervention of bankers or accountants, great numbers of balance-sheets underwent tremendous changes. The assets side was scrutinized by the boss himself before the books were closed and, if there was the slightest indication of overvaluation, ruthless cuts were made in the book figures. Plant accounts were written down to the lowest possible point by liberal depreciation charges and by reductions in amortization or obsolescence. Inventories of raw materials and finished products were reduced to a cash basis. The most liberal reserves were provided for possible losses in accounts receivable. All possible liabilities were set up in the books. This same policy was continued throughout 1918, so that the average balance-sheet of the most recent date obtainable, speaking from the point of view of a lender of money or from that of a public accountant, is a joy to behold. I refer, of course, to those cases in which there were profits in 1917 and 1918 subject to the higher rates of federal taxes. Where there were no such profits the procedure outlined was not followed, nor could it be expected that it would be followed.

As most business enterprises were successful during 1917 and 1918, or both, the pruning process was almost general. In my comments, therefore, I will confine myself to what I might call those balance-sheets which underwent the heroic treatment mentioned. While the pruning of balance-sheet operations was drastic, yet it is a fact which must not be ignored that the inventory figures which remain after all deductions and reserves have been taken into account are far above pre-war values and that, if pre-war prices were to prevail again within the near future, it is questionable whether our apparently favorable balance-sheets would be able to stand the cuts which the application of pre-war prices would require. I think, however, that the chances of ever getting back to pre-war prices are too remote to justify any preparation therefor. The purchasing price of a dollar today is so much less than it was a few years ago that it would require a violent upheaval, not now in sight, even to approach former conditions. We have a tremendous inflation in our own currency with a far greater inflation in the currency of other countries. It is impossible that the return to conditions of non-inflation should be rapid. Labor costs, which are the highest factor in many industries, are going down slowly, if at all. In many industries where wages should be reduced, pressure against reduction is hard to overcome. This pressure comes not only from labor and the representatives of labor, but from many other sources.

A lender of money cannot ignore the radical tendencies not only of labor reformers but of parlor socialists as well. The latter are far more numerous than many realize. They are found as mayors of our largest cities, in the pulpit and among borrowers of money. We find bankers and lawyers who have made large fortunes, which are safely invested, among our leading reformers and informers. As General Wood recently said, "Strange doctrines are preached in high places." It is curious how many wealthy people, who become inoculated with the germ which sanctions the reduction of the fruits of labor of others, tenaciously retain their own wealth. It is too bad that certain rich men do not borrow money. I would like to be the banker to whom they applied for loans.

Balance-sheets are affected by sentiment and by many intangible elements. Strikes, bombs and threats may turn a good balance-sheet into an unsatisfactory one.

It is of great importance that the adjusted balance-sheet of the present day be continued. Over long periods of years and in many thousands of concerns it has been demonstrated that the capitalization of such items as advertising, etc., has been a mistake. It has been found that very liberal depreciation, writing down of inventories, etc., has led to business success. The tendency of the treasury department to disallow such items should be criticised. I will admit that what is known as correct accounting may lead to overcapitalization and inflated profits. In deciding whether an expenditure should be capitalized or charged as an expense it is better to be conservative than accurate.

If bankers will in future years require balance-sheets to be made up on the same basis as the average balance-sheet at the end of 1918, losses due to bad loans will diminish. I insist, however, that much that was commendable in the house-cleaning as applied to balance-sheets was due to high taxation rather than to a change in sentiment. But when the devil was not sick he was not a monk.

When tax rates go down (if they ever do) or if profits decline (which they will) the recent liberal and conservative methods may not continue. For the sake of the borrower himself, bankers should insist on a continuance of the methods of the last few years. If there is a gradual decline in prices, it can be taken care of without any difficulty. Wherever there is a drastic decline in prices, it should be immediately applied to the balance-sheet, no matter who is hurt.

In the great majority of cases balance-sheets are still far from being a true picture of financial conditions. There should be some basis of comparison between concerns in the same industry, buying the same raw materials and producing the same articles. As a member of the price fixing committee in Washington, I was amazed at the tremendous differences which existed in this respect. Even when costs of production were somewhat similar, balance-sheet valuations were widely apart. This applied not only to a few industries, but to most industries. We were told by the leaders of various industries that a certain amount of capitalization could be counted upon in relation to a given unit of production or capacity. But few concerns reflected any such uniform or standardized figures on their balance-sheets. If price fixing had continued for any great period of time, it is altogether likely that there would have been a radical revision of balance-sheet valuations.

I refer only to valuations of fixed assets, such as plant, machinery, etc. This would have been influenced by the fact that we were endeavoring to fix uniform prices which would yield a satisfactory profit or return on investment to the average concern in a given line of business. We could not legislate for the high cost concern nor the weak sister. And we were willing that the low cost, efficient producer should realize a higher return on his capital than the high cost inefficient producer.

One of the great difficulties in price fixing was the fact that concerns in the same industry rarely built their plants at the same time. Some built when materials and labor costs were low. Others built when costs were high. Some wrote their plants down to $1.00. Others did not even charge off ordinary depreciation.

It is easy to imagine the difficulties confronting those of us who were attempting to give to our most important industries a fair return on their investment. Here is a factor of considerable importance. The plant which was built at war prices (which still continue) is at a disadvantage as compared with a plant built at pre-war prices and over-depreciated as well.

The attention of the lender of money is not always directed to the basis of plant valuations. Theoretically money is not lent on fixed assets. This theory, however, contains a great fallacy, because it would be far better business to lend money to a concern which had a plant of good earning capacity, even though its liabilities were 100 per cent. of its quick assets, than to a concern whose liabilities apparently only amounted to 50 per cent. of its quick assets, which had a poor plant and was not making good money. There is a direct connection between plant assets and valuations and the profit and loss account to which bankers do not always give enough consideration.

There has been some tendency to treat accrued federal taxes as a reserve or as a possible liability, rather than as an actual debt to be paid in cash on fixed dates. In many cases the amount payable is a rough guess. In some cases the amount is entirely omitted from the balance-sheet. Considerable pressure has been exerted upon public accountants to omit the amount payable and merely mention the fact of the omission. The point is not even debatable. If a profit has been earned a considerable part of it must be set aside for federal taxes. In the state of New York the amount payable under the new law is not inconsiderable. It is not difficult to ascertain the amount due. No balance-sheet should be accepted by a banker unless the tax liability is set up, and if there is any doubt about the amount the estimate should be ample.

Some bad advice has been given in regard to taxes. I know of balance-sheets in cases in which the taxes which will have to be paid will be ten times the amounts shown on the balance-sheets. The amounts shown are those which uninformed persons think can be put over the treasury department. There will be sad awakenings in many, many cases. If I were a banker I would insist on some verification of the item of tax liability.

I do not like the term balance-sheet. The term itself is ill-chosen and I am sure that it at least is partly responsible for the curse of balancing. The trouble with most balance-sheets is that they balance. I have no possible objection to a bookkeeper's being able to balance his books. In fact I would not employ a bookkeeper who did not understand the gentle art of balancing, just as I insist that my thirteen-year-old boy must study Latin and algebra. Balancing and Latin are forgivable as elements of a liberal education, but they should not be made offensive. Instead of a balance-sheet (which always balances) bankers should call for a statement of assets and liabilities and if it balances it should be returned for correction. Very frequently balance-sheets upon which large amounts of money are lent are exactly what the name implies, that is, certain figures are extracted from the debit and credit sides of ledgers and in turn are transferred to sheets of paper without any intelligent thought being given to the relationship of the figures to the things which the figures are supposed to represent. Even if a bookkeeper should at the time of transferring the figures realize that some of his figures did not at all represent the things themselves, what I call the curse of balancing would prevent a correction. He would be afraid to make the correction because if he did so the balance-sheet would not balance. The ideal balance-sheet is one which does not balance because in such case no one fears to decrease an asset if it is overvalued or hesitates to increase a liability item or insert an additional liability if it is found that all are not on the books.

Balancing has so overawed bankers and business men that many of them would as soon remove an ancient land-mark or make light of sacred things as strike out one figure on a balance-sheet and insert another. The chief use of a statement which balances is the smug satisfaction it affords to the bookkeeper. It does not signify accurate or trustworthy accounts. Many of the flagrantly false accounts which I have seen were in perfect balance and so far as looks were concerned could not have been improved. I can't emphasize too strongly the importance of getting at the substance of a balance-sheet and subordinating its form. I do not belittle the importance of having a balance-sheet in proper form. I have spent many weary hours in recasting balance-sheets so that they could be readily understood. In my opinion the simplest and best form is that which shows quick assets first, grouped according to convertibility and availability, with the totals shown, then followed by fixed and other assets in the order of their convertibility. On the liability side I would show the liabilities in the same order, that is in the order in which they must be paid. I would place bond or long term debts next, and last of all I would show the net worth carried out in one aggregate. Some balance-sheets which show capital stock as the first item of liability and surplus as the last item of liability are not only misleading (because capital stock and surplus are not liabilities) but they require mental gymnastics in order to get at the actual net worth of the concern.

If the borrower has not put his own house in order, there has never been a better chance for the banker to do strong arm work on balance-sheets than at the present time. They should be made to reflect actual conditions and conservative values and there should be enough uniformity about the balance-sheets of a given industry to make comparisons possible and profitable. Every bank which lends money should classify its balance-sheets and not consider that each one should be expected to tell its own story. Management is just as important as capital and a balance-sheet can and should reflect management. The war balance-sheet may show large net worth but it does not necessarily reflect good management, because large profits were made by the majority of concerns. Anyone could make money in most industries during war times because the demand exceeded the supply. The profits so made have been used to clean up balance-sheets. The important thing now is to prevent balance-sheets from getting into their former condition. As heretofore stated the only concerns which really cleaned house were those which were profitable from 1916 to 1918. As the tax problem was the incentive to clean house, those concerns which were not subject to high rates of taxation should have their balance-sheets more carefully scrutinized than those in the more fortunate class.

The pressure on a borrower to furnish a good statement comes not only from his own needs, but frequently from note-brokers and bankers. High tax rates, growing out of war conditions, have inclined many concerns to make up statements which can safely be trusted. Obviously, such statements are the safest ones on which to lend money. The same acid tests should be applied to all balance-sheets, and then it will be found that the influence of the war upon balance-sheets has been helpful alike to the borrower and to the lender.