ACCOUNTING KEEPS PACE WITH THE TIMES

Address of

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The invitation to appear here this evening carried with it a firm suggestion that "generally accepted accounting principles" would not be a suitable topic for discussion. It is a little difficult for an accountant, whether corporate executive or in public practice, to escape that phrase today, but since I have been warned I shall avoid it as I would the plague. Instead I intend to look around for some evidence that progress is being made in financial reporting--something a little stronger than mere straws in the wind--perhaps a silver lining in the clouds of conflict.

Recent bulletins of the Committee on Accounting Procedures of the American Institute of Accountants offer a good point of departure. Approval by that committee, as a current objective, of the recommendation of the Committee on Terminology with respect to the use of the term "reserve" in accounting is a gratifying step toward elimination from financial statements of words confusing to the layman. The proposal is to limit the use of the term "to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose, as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacements of property, or (c) for possible future inventory losses, or (d) for general contingencies. In this sense," the committee says, "a reserve is frequently referred to as an appropriation of retained earnings." It is recommended that the use of the term by discontinued in the balance sheet in describing deductions from assets or provisions for particular liabilities and altogether in the income statement. On this point the American Accounting Association in its recently revised statement of "Accounting Concepts and Standards Underlying Corporate Financial Statements" recommends that the balance sheet should contain no special section for reserves but that each should be identified as a sub-division of retained income, valuation account or liability, and disposed accordingly in the balance sheet. The language of the statement is not as forthright as it might be with respect to elimination of the use of the term.

It may be charged that these two recommendations reflect a theoretical ideal unattainable, at least not at once, in practice. That the situation is not hopeless seems to be clear from N. Loyall McClaren's excellent discussion of "Annual Reports to Stockholders". He says the term "reserve" should be dropped from the liability group "forthwith", and hazards a guess that certain prominent industrial companies retain valuation reserves on the right-hand side of the balance sheet either because of "(1) pride of heritage, and custom or (2) in the words of Milton, 'fear of change perplexes monarchs.'" With respect to the third category--appropriations of surplus--McLaren says these should be shown in the capital and surplus section of the balance sheet and he praises two companies for being "among the trail blazers in correcting a major weakness in current financial accounting." An annual report to stockholders which came to my attention just a few days ago is an excellent example of this point. The Chain Belt Company balance sheet at October 31, 1948, contained in the report shows the following:

"Earnings retained and invested in the business –

Appropriated for contingencies from earnings of prior years— no change during year …………	$1,284,508.64	
Unappropriated—see statement attached…………………………	9,226,884.97	$10,511,393.61"

This subject presents a practical problem for the S.E.C. When Regulation S-X was adopted a complete three-way segregation of reserves was deemed to be too radical a step to take. The term "reserve" is used throughout the regulation which does require, except for fixed asset reserves of public utilities (and we think it is time to remove that exception), that valuation reserves be deducted from related assets. The unsettled state of the remaining reserves, however, was recognized by the caption "Reserves, not shown elsewhere." We hope that the time has now come when this item can be eliminated in our next revision of the regulation which we now have under consideration and with respect to which we would appreciate constructive suggestions from all interested users.

Discussion of new terminology in referring to items currently designated "reserves" leads naturally to a consideration of substitutes for the term "surplus". Some large corporations have approached the problem cautiously by introducing parenthetical explanations such as "net income retained for use in the business" following the caption "Earned Surplus" in the balance sheet. Others have abandoned the term "surplus" completely and substituted "profit employed in the business", income retained in the business", "net earnings retained for use in the business", "accumulated earnings—in use in the business", "reinvestment of profits" and "earnings employed in the business". We have been asked whether these expressions would be accepted as substitutes for "earned surplus" in financial statements filed with the Commission. Subject to possible complications in individual cases, we have replied that these phrases are not only acceptable but are a desirable step in improving investor understanding of the statements in which they are used. That this is a step in the right direction can be tested by asking almost any non-accountant what is meant by the term "surplus". I think, too, that much of the current discussions involving stockholders, labor and management as to who is entitled to get what could be avoided by the use of a truly descriptive caption with respect to what is now so generally referred to as "surplus". A very interesting attempt to explain surplus and profits to their women investors may be found in General Foods Corporation's third quarter report for 1948 in which the president of the company tackles some of the misconceptions with respect to both terms while avoiding their use in the accompanying statement of earnings.

Corporate financial history in many individual cases will present complications which will require special disclosure. A common example is the situation in which earnings have been capitalized by the payment of stock dividends or by an increase in the stated value of any class of outstanding shares. Consideration must also be given to the proper presentation of appropriations from surplus to reserves or to indicate restrictions on surplus from a variety of causes. An unqualified use of the suggested substitute terms would appear to be technically incorrect and misleading when earnings have been capitalized or appropriated and shown otherwise than as a part of the recaptioned earned surplus.

Assuming that no earnings have been capitalized by a restatement of capital, a recent report of one of our largest corporations offers a solution to the display of appropriations from earnings as follows:

Earnings employed in the business:	
Appropriated for:	
Inventory price decline	$ xxx
Contingencies	xxx
Workmen's compensation insurance	xxx
Payment of interest and sinking fund on debentures	xxx
Cost of retirement of preferred stock	xxx
Unappropriated	xx,xxx

A variation of this presentation could be made to handle the stock dividend complication, perhaps in this manner:

Accumulated earnings – in use in the business	$xxx,xxx	
Less: Added to capital stock through stock dividends	xx,xxx	
Balance not capitalized	$xxx,xxx	
Appropriated for:		
Inventory price decline		$ xx,xxx
Replacement of plant at higher prices		xx,xxx
Contingencies		xx,xxx
Self Insurance		xx,xxx
Unappropriated		xxx,xxx

This form of reporting properly classifies that incomprehensible group of reserves commonly shown between "liabilities" and "capital and surplus" concerning which it is left to the reader to decide the treatment to be given in analyzing the financial position of the reporting company. The company's officials and independent accountants should be better qualified to make a proper disposition.

Adoption of this procedure may present another difficulty in some old companies, a difficulty recognized in Regulation S-X which specifies a division of surplus into "(1) paid in surplus; (2) surplus arising from revaluation of assets; (3) other capital surplus; and (4) earned surplus." The rule goes on to provide that "if, in the accounts, separate balances for these are not shown at the beginning of the period of report, i.e., if the company has not, up to the beginning of the period of the report, differentiated in its accounting for surplus as indicated above, then the unsegregated items may be stated in one amount. If the above segregation of surplus is not made, the account titles used shall be such as will indicate the general types of surplus included therein." Except in very rare cases it is believed that the condition requiring the exception in this rule can be obviated by appropriate analysis of the accounts. Suggestions as to how this rule can be amended to provide for the modern trend toward abandoning the use of the term "surplus" are in order.

There is one subject which has brought us a few inquiries but which many accountants might characterize as a mere tempest in a teapot. In view of the detailed discussion it contains and its unanimous adoption by the twenty-one committee members, the uproar following the publication of Accounting Research Bulletin No. 30 which provides for the inclusion of prepaid expenses among current assets is really remarkable. It seems likely that there would be very few cases in which the amount of prepaid expenses would be material by any test. In response to a question as to whether we would accept their inclusion among current assets, we have cited the instruction in Regulation S-X under "Prepaid expenses and other deferred items" that "prepayments of services to be received within one year may, however, be included under [other current assets]." Application of the Institute's operating cycle rule is construed to be substantial compliance with our rule.

A much more significant problem in connection with current assets is what disclosure should be made when inventories of material amounts are carried on a "lifo" basis which is substantially less than the amounts would be on a more nearly current value basis such as "fifo" or average cost reduced to market, if lower, or current replacement cost. The difference in valuation at any balance sheet date has come to be very substantial in some lines of business and has been a subject for comment in reports to stockholders. The most recent example to come to my attention is a report of a large carpet company in which the effect of employing the "lifo" method of inventory valuation is explained. The news account says that the president of the company explained that profits are on the basis of the cost of replacements of raw materials used and do not include inventory profits. It is stated further that the market value of materials on hand in inventories last December 31 was about $10,000,000 greater than the $21,000,000 total carried in the balance sheet. The president of the company went on to say "that it should not be inferred that this $10,000,000 will be reflected in profits at some later date. It does, however, represent a cushion in that amount against having to incur losses later on by reducing inventory values when the market for raw materials declines. This safeguard against a decline in raw material prices has been accumulated over the last ten years as a result of the last-in, first-out method of inventory valuation," he explained.

Reference to "lifo" as a method of avoiding future inventory losses seems to me to be just another way of saying that when prices decline the profits will be greater under the method outlined than they would be under the first-in, first-out method and the profits of the past ten years in this case have been less than would have been reported on the first-in, first-out method. This is precisely the result sought by the adoption of "lifo". Whether the difference in inventory balances resulting from the use of “lifo” when compared with some other basis is an item of information which should be disclosed in all cases is a subject of current debate in accounting circles. To the analyst who is accustomed to attach some significance to the current ratio and other ratios in which the inventory is a component and whose standards of comparison have been related to inventories valued on “fifo” or average cost, the information given by the carpet company seems essential to avoid erroneous conclusions.

A current report of a company in the agricultural machinery and tractor business reveals a material difference in inventory values accumulated in only two years’ time. The December 31, 1948, inventories, in this case amounting to $50,000,000, are reported as “stated on basis of approximate cost at January 1, 1947”. A footnote explaining the basis states that the replacement cost of these inventories was approximately $61,000,000. An oil company which changed to the “lifo” basis on the same date as this company disclosed in a footnote in its report for 1947 that inventories at December 31, 1947, on a “lifo” basis were $10,000,000 less than they would have been on the average cost basis formerly used. This change relates to inventories amounting to $34,000,000 on the “lifo” basis. These certainly are materially significant figures both with respect to amounts and the short time in which the differences developed.

Another aspect of the problem arises in connection with summaries of earnings and other forms of comparative profit and loss analysis such as in comparing the results of one company with others in the industry. There is no question as to the necessity for disclosing the effect of a change in inventory valuation methods in the year in which the change is made. Doubt, however, arises as to proper disclosure in an earnings summary covering ten years when, say, the first five years’ results are on a first-in, first-out basis and the last five years are on the last-in, first-out basis. We have recognized the desirability of disclosure of the effect of such a change in a situation in which the company involved was the only one in its field using the “lifo” basis of inventory valuation. However, even here the differences in results by years must be subordinated to the results reflected by the method adopted for keeping the accounts of the company, otherwise the situation smacks too much of an “eat your cake and have it too” approach. Here the supplementary explanation, it may be admitted, was useful for industry comparison, yet it seems obvious that the balance sheet at the end of the ten-year period presented on the “lifo” basis and the earnings determined on that basis rather than the “fifo” basis figures constitute the management representation of dividend paying capacity of the company.

Serious consideration must be given to the view that to disclose an inventory valuation on some other basis after the adoption of “lifo” for accounting purposes may be considered a reflection on the validity of the “lifo” treatment. Despite the growing popularity of “lifo”, even beyond the lines of business for which it was originally adopted, there are many accountants who sincerely believe that the idea has spread beyond its original and appropriate use or condemn it entirely. Others warn that to disclose current replacement value when higher than the “lifo” valuation may be misleading--particularly if the trend of prices is downward. Certainly in such circumstances the manner in which the disclosure is made should be approached with caution. Still another warning that has been made is the possibility of the investor, and other users of the financial statements, interpreting the excess of replacement cost over the “lifo” figure as additional surplus. My carpet company example suggests a means of dealing with this problem but there are some people who feel that no such explanation will be convincing to the average reader of financial statements.

In the forms of financial reporting prescribed by the Commission for commercial, industrial and mining companies in the promotional, exploratory or development stage, the conventional balance sheets and profit and loss statements have been supplanted by separate statements of assets and capitalized expenses, liabilities, capital shares, other securities, and cash receipts and disbursements. These statements were first prescribed in 1936 for registration statements of corporations organized within two years to engage in the exploitation of mineral deposits other than oil or gas. Subsequently the idea was extended to registration statements of other corporations, except insurance and investment companies, in the promotional stage and devoid of active subsidiaries and other corporate complications. The currently effective forms prescribing these statements are S-2, S-3 and S-11. Last October these forms of financial statements were published in an Accounting Series Release providing for their incorporation in Regulation S-X and extending their use to applications for registration on Form 10 and annual reports on Forms 10-K and 1-MD when filed by commercial and industrial companies in the promotional or development stage or by mining companies if all the following conditions exist with respect to a particular company:

(1) it is not in the production stage but is engaged primarily in the exploration for or development of mineral deposits other than oil, gas or coal;

(2) it has not been in production during the period of the report or for the two years immediately prior thereto, except that being in production for an aggregate period of no more than eight months over the three-year period shall not affect the use of the form; and

(3) receipts from the sale of mineral products by the company and its subsidiaries combined have not exceeded $500,000 in any of the most recent six fiscal years and have not aggregated more than $1,500,000 in the most recent six fiscal years.

It is too early in the new year to cite any instances of the use of these financial statements in annual reports under the Securities Exchange Act of 1934 but recent filings under the Securities Act of 1933 include mining companies on Form S-3 and S-11 and a company organized to exploit a mechanical device, a horse racing association, and a Canadian oil company, all on Form S-2.

The form and content of the statements as incorporated in Regulation S-X are substantially the same as those incorporated in Forms S-2, S-3 and S-11 as they include captions which may be required for companies using any of these forms. In extending the use of the statements to annual reports it was recognized that old established mining companies, though inactive for a sufficient period to warrant use of the simple forms here under discussion, would very likely be keeping their books on a strict accrual basis. This situation has been met by providing that the items of income and expense reported in the statement of cash receipts and disbursements may be presented on the accrual basis as recorded on the books provided entries are introduced in the statement to reconcile the figures in total to the cash receipts and cash disbursements respectively. A mining company prospectus recently filed contains a statement of Sources and Application of Funds which seems to me to be substantial compliance with the intent of this instruction. The statement is in columnar arrangement presenting three calendar years and a fraction of a year. Sources of funds are sale of securities, loans, sale of equipment and supplies, boarding house revenue, and machinery rental. Disposition of funds discloses mine development (twenty-two subdivisions), mine equipment, buildings, and payment on note. The statement is closed by adding working capital at the beginning of the period to the difference between sources and disposition for the period, thus arriving at working capital at the end of each period, the last balance agreeing with the difference between current assets and current liabilities shown on preceding pages.

It may be noted that this substitution in form of financial statements is permitted in our recently revised registration forms and is being incorporated in others as they are revised. Revision of the instructions to Forms 10 and 10-K in this respect was announced in the release adopting the amendment of Regulation S-X to include these forms of financial statements. Since this provision of our rules may not be as well known as it should be, I quote it in full as incorporated in the instructions just mentioned:

> "If, in any case, the statements herein required are inadequate or inappropriate, the Commission may, upon the informal written request of the registrant, permit the omission of one or more of the statements herein required and the filing in substitution therefore of appropriate statements of comparable character. The Commission may also by informal written notice require the filing of other statements in addition to, or in substitution for, the statements herein required in any case where such statements are necessary for a proper presentation of the financial condition of any person for which financial statements are required, or for which such statements are otherwise necessary for the protection of investors."

A recent issue of a weekly magazine describes the operations of a specialist in a form of corporate financing which has had a rapid postwar growth in popularity. "The plan," the article says, "consists of selling real estate, then hiring it back from the buyer under a long-term lease, with renewal options stretching into the next century. What this amounts to is converting brick and mortar into working capital without recourse to banks or the public." This is recognized in financial, accounting and legal circles as "net-lease" financing and has been the subject of a limited amount of discussion in the professional press of these circles.

There are several variations of this basic pattern indicated by the quotation above. In some cases the assets are not originally owned by the lessee, but are purchased or built to his specifications by the lessor. In some instances the financing is done directly by the lessor but in most cases it is accomplished by obtaining a loan from a third party, usually an insurance company or educational institution. The loan is secured by a mortgage on the property, and often the lease agreement is also pledged to the lender as additional security. The lessee, in the usual arrangement, is responsible for taxes, insurance, and maintenance and repair costs. There is nothing new about this aspect of the case, as a letter published last week in a Washington paper indicates. It seems that George Washington built two expensive houses near the capital in 1799 and offered them for rent at 7-1/2% of their actual cost. The tenant, however, was to pay taxes, fire insurance and keep the property in repair.

The "net-lease" has three principal advantages from the viewpoint of the lessee over the more conventional method of acquiring the use of assets through purchase financed by a mortgage. First, by permitting the sale of fixed assets it furnishes a source of working capital. Second, the fact that fixed assets are converted into cash without the concurrent showing of a mortgage liability has a beneficial effect upon reported financial condition. Third, there is a tax advantage arising from the fact that the entire amount of the periodic payments under the lease is deductible as an expense, whereas only the interest portion of a payment on a mortgage is deductible for tax purposes. This latter advantage, however, is partially offset by the lessee's loss of the deduction for depreciation. It must also be considered that the lessee loses title to the property, and at the end of the lease period must either repurchase it or enter into another lease agreement. At the present time, due to the price situation, there is generally an additional advantage to the lessee in that he realizes a profit on the sale.

"Net-lease" financing is employed principally by retail merchandising organizations, particularly those having numerous outlets. A few such companies which have made use of this device are Safeway Stores, Inc. (credited by many with having started the trend to this type of financing); Sears, Roebuck & Co.; Montgomery, Ward & Co.; Allied Stores Corp.; J. C. Penny Co.; F. W. Woolworth Co.; J. J. Newberry Co.; Butler Brothers; and Federated Department Stores.

The use of "net-lease" financing is not, however, confined exclusively to retail merchandisers. It is also employed by industrial and public utility organizations, including such well known companies as General Motors Corporation; Continental Can Co., Inc.; Koppers Co.; Western Union Telegraph Co.; E. R. Squibb & Sons; Fruehauf Trailer Co.; Liquid Carbonic Corp.; and Sterling Drug, Inc.

The policies and activities of Safeway Stores, Inc. in the field of "net-lease" financing are representative. They are described briefly in its Form 10-K annual report for 1947 filed with the Commission, from which I quote:

> "It is the policy of registrant to conduct its operations and those of its subsidiaries in premises which are held under lease rather than in company owned properties. Accordingly, all premises used for retail store operations on December 31, 1947, were held under lease with the exception of 25 locations . . . which were owned in fee by the registrant and its subsidiaries . . .
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> "The registrant and its subsidiaries on December 31, 1947 owned retail store buildings which had been constructed upon leased land at 10 locations . . . owned 109 parcels of land . . . upon which it plans to construct retail store buildings with adjacent

parking lots . . . (and) also held under lease 169 locations . . . upon which it proposes to construct store buildings at an estimated cost of $9,295,000.00.

"During the year 1947 registrant constructed 7 store buildings on land purchased for this purpose, as well as 2 store buildings on leased land . . .

"Registrant plans to continue the program described in previous annual reports of purchasing land, constructing or having constructed thereon suitable buildings and improvements and then selling the completed properties to investors, taking back leases thereon, and the properties described above were acquired as a part of said program. Registrant also proposes to sell improvements constructed on leased properties to the property owners or to purchase the land and sell the completed locations to investors taking back leases thereon."

Elsewhere in the report it is revealed that as at February 28, 1948, Safeway and its subsidiaries occupied under lease 1,000 stores, warehouses and plants, including sites for future warehouses and stores, which had been purchased or built by Safeway and its subsidiaries and sold to the present lessors at or around cost. The leases contain cancellation clauses exercisable at the option of the lessees; but in the event the options are exercised the lessees must offer to repurchase the property at the lessor's purchase price, less specified amounts which vary with the length of time the lease is held. The total purchase price of such properties at February 28, 1948, was about $33,380,000. It is also pointed out that in a number of instances the lessees are required to pay taxes, insurance and maintenance in addition to the rents under the leases.

Our requirements with respect to the treatment of "net-lease" contracts depend upon the terms of the contracts. There are, basically, three types of contracts. Some are simple lease arrangements containing no provision for acquisition by the tenant of title to the property. Specific instructions for the reporting of long-term leases, including those of the type under discussion, are now prescribed in Item 5 of Rule 12-16 of Regulation S-X, dealing with "Supplementary Profit and Loss Information", which requires that the aggregate annual amount, if significant, of the rentals upon all real property now leased to the registrant and its subsidiaries for terms expiring more than three years after the date of filing, and the number of such leases, shall be stated. If the rentals are conditional the minimum annual amount thereof is to be stated. In my opinion, it is also essential, in view of the fixed commitment involved, that adequate information with respect to such leases be submitted as supplemental information to the balance sheet, preferably in the form of a footnote.

A second type of contract involves the purchase or repurchase of the property by the lessee, and provides that the periodic payments made under the agreement will be applied against the purchase price of the property. Such arrangements are, in my opinion, clearly purchase or repurchase contracts, and should be shown at their full contract cost, less appropriate allowance for depreciation, on the asset side of the lessee's balance sheet, with the liability under the purchase contract reflected under an appropriate caption on the liability side. Here, again, adequate information concerning such arrangements should be appropriately disclosed.

The third type of “net-lease contract” incorporates an agreement which permits but does not obligate the lessee to acquire title to the property either during the life of the lease or upon its termination. In my opinion it is necessary to go beyond the form of such contracts and determine whether, in substance, the lessee actually intends to acquire the property. Among the factors to be weighed in reaching a decision are:

1. Whether the rentals are to be applied against the purchase price, and if so, whether they are out of line with rentals under leases not containing acquisition provisions;

2. The estimated value of the property at the time the purchase option becomes exercisable as compared with the agreed purchase price, if any;

3. Whether the contract provides for an extension of the lease period, and the amount of the rentals to be paid during the extended period.

If it is determined, after consideration of all the factors in a particular case, that the agreement is in fact a purchase or repurchase contract, it follows that it must be reflected in the balance sheet as in the second type of case. If, on the other hand, the agreement constitutes a bona fide lease arrangement, it will be necessary only to submit the required information as a supplement to the financial statements as in the first example.

Another variation of the “net-lease” procedure is the practice whereby a parent company transfers property subject to a mortgage to a wholly-owned subsidiary, and then leases back the property; in some cases the subsidiary has been created for this specific purpose. It seems to me that under these circumstances consolidated statements of the parent and such subsidiary are necessary to properly present the financial position and results of operations of the company.

Only consolidated statements can adequately disclose the assets and liabilities of a business enterprise in which significant amounts of the fixed assets used by the parent are owned by a subsidiary.

Most of the articles concerning “net-lease” financing appearing in various financial and accounting publications either do not refer to the dangers inherent in this practice, or give them only passing mention. The principal danger to the lessee is, of course, the fixed commitment for a long term of years. In the cases which have come to my attention the arrangements do not appear to be subject to adjustment to conform to changes in business conditions, a situation which, in periods of declining business activity, might well become so burdensome as to cause failure of the business.

A case in point is that of the Childs Company. The Commission's advisory report[1] on the proposed plans of reorganization of this company discloses that the "need for cash to repay bank loans caused the company to dispose of a number of its best properties and take back leases at rentals which later proved burdensome." Among the factors enumerated by the trustee as contributing to the chain's financial difficulties were excessive rentals paid by many of the stores and obsolete restaurant locations which were impossible to abandon because of lease obligations.

It is true, of course, that the purchase of property subject to a mortgage also commits the mortgagor to periodic payments of interest and to repayment of the principal amount. However, the number of such commitments which may be incurred by any one mortgagor is somewhat restricted by virtue of the fact that ordinarily a mortgage cannot be obtained for the full value of the property, and the purchaser must provide the balance himself. This restriction is not present in the typical "sell-lease" transaction, and consequently there is a real danger that the lessee will commit himself for payments which he will be unable to meet under adverse conditions. This possibility is behind our conclusion that full disclosure of such lease obligations is necessary in order to make the financial statements not misleading.

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[1] Corporate Reorganization Release No. 67, September 30, 1946.