ACCELERATED DEPRECIATION, LEASE-BACKS,

PENSIONS AND OBJECTIVE EVIDENCE

GEORGE O. MAY

In the monograph which I prepared at the request of the Executive Committee of the Study Group, and which was recently circulated to members, I dealt mainly with broad concepts of income and with the specific questions which the Executive Committee had decided to study. These questions related to the allocation between periods of inventoriable and depreciable costs incurred in the past.

Since the Committee met last spring, and asked me to prepare this monograph, emphasis has shifted dramatically from accounting for physical assets to problems relating to money claims held by, or against, business corporations. Devaluation, lease-backs, and pensions present problems in the formulation or implementation of concepts of income. The new developments have created additional doubt as to the validity or adequacy or uniformity and comparability as primary objectives of accounting, and of reliance on "facts" and "objective evidence" as means of attaining those objectives.

Devaluation is a recognition of a decline in the value of monetary assets held by American companies abroad which has been taking place over recent years, but which exchange controls have made it difficult to measure from month to month, as was possible when the exchanges were free. This development raises sharply the question – how far is it wise to prohibit, or discourage, provisions for losses "in amounts not determined on the basis of any reasonable estimates of costs or losses." (Accounting Research Bulletin No. 28, par. 3 (d).) If it is possible to foresee, with reasonable assurance, that a loss will occur, and that it will not be less than a certain minimum, is it wise to discourage making a provision of that minimum because the maximum amount is not presently foreseeable?

The proper accounting for leases is closely related to the question of accelerated depreciation of postwar construction costs which are regarded as high or excessive.

In the November issue of the Journal a recent chairman of the Committee on Accounting Procedure and President of the Institute in discussing accelerated depreciation pleads for intelligent variation and greater reliance on managerial judgment as the necessities of the present time, though he does not abandon hope of an ultimate approach to standardization and uniformity.

The November Journal also contains an editorial referring to this article and discussing “accelerated depreciation of ‘excess costs’ or plant, exemplified by the Chrysler accounts.” From the Chrysler accounts it appears that its method was to write off the excess of postwar cost over estimated prewar cost over a three-year period. It expresses the view that “there can be no quarrel with the theory of accelerated depreciation, so long as it is applied in a systematic manner in accordance with objective standards.”, and that “Since obsolescence is a factor in depreciation, it can be argued persuasively that excess costs of a plant constructed to take advantage of a high price market should be written off over the period in which that market is expected to exist.”

Applying the logical method advocated by Dr. Schmidt, in an interesting article in the same issue, it would appear that this conclusion implies a premise that there is a relation, which can be measured by objective standards, between excess costs as defined and the appropriate prospective book value of the facility when the high price market has come to an end. The validity of this premise is open to serious doubt. The writer of the article, to which the editor refers, takes the position that “acceleration must be a matter of individual management judgment.” (p. 377)

The editorial goes on to say that this method of accelerated depreciation of excess costs has obtained authoritative approval. If this is so, the profession should be advised of the source of the approval, its form and its scope. Having searched the Bulletins of the Committee on Accounting Procedure I do not find any support for the procedure in them. The part of <u>Accounting Research Bulletin No. 28</u>, which I have already quoted, seems to be to the opposite effect; however, accounting does admittedly permit a provision for obsolescence and such a provision could not be brought within the limits permitted under this part of the bulletin.

<u>In Accounting Research Bulletin No. 31</u> the Committee disapproved, as regards inventories, all provisions based on an expectation of a future decline in price levels. The same reasoning might be held to apply to the accounting for plant assets which are often regarded as long-term inventories.

The statistics relating to 525 annual reports for 1948, recently published by the Institute, show only three companies accelerating depreciation on a "portion" of cost.

There is much to be said in favor of reconsideration of the methods of providing for exhaustion of the cost of new property in the light of new conditions. I suggested that such a reconsideration was probable in an address which I made at a meeting of the Controllers Institute in 1941. I do not believe, however, that the relation between prewar and postwar prices affords a satisfactory measure of the extent of the acceleration that is either theoretically or practically desirable.

When I was getting my first lessons in accounting, nearly sixty years ago in England, the diminishing balance method was in high favor there. I felt a certain regret when the English Institute announced some five years ago that the straight-line basis was preferable. I was, therefore, gratified by the kindly reference made by the writer, to whom the editor refers, to "the good old practice," and his suggestion that it should be given asylum here, where it would no doubt find many friends, though few relatives. However, despite its merits, adoption of the diminishing balance method would be open to the same objections on the ground of uniformity and standardization as were urged against recognition of higher price levels in depreciation accounting. Here again, I agree with the writer of the article that what we need at the moment is intelligent variation of method fully disclosed rather than wooden uniformity. This view finds strong support in the evidence of improvement by innovation supplied by the statistical summary of annual reports made available by the Institute.

It would, I think, be erroneous to assume that straight-line depreciation rests on an implied premise that the particular facility may be expected to be useful ratably over its physical life. If a facility were leased for its estimated useful life at a uniform rental, the more appropriate method would be the annuity or sinking fund method which would result substantially in showing a uniform rate of return on the amount of investment that would remain unamortized from time to time. Use of the straight-line method would tend to result in showing the same amount of return in the first and last years, though in one case the investment to which the return would be applicable might be twenty or thirty times as great as in the other. One of the merits of the straight-line method is (as was pointed out in the Journal of Accountancy, October 1935) that it is well placed between the diminishing balance and the sinking fund or annuity bases of depreciation.

Consideration of this illustration leads naturally to the problem of leases and lease-backs.

A manufacturer may desire to create a new facility and finance it from outside sources. Strict limitation of funded debt and plowing back profits have created a high credit rating for many manufacturing companies. A financial institution might, therefore, be willing to finance the cost of the new facility and to do so in any manner which the manufacturer might deem most advantageous to himself, subject only to the requirement of substantial payments in the early years of operation. This feature of the scheme might be advantageous to the manufacturer, particularly if he could be sure of getting the benefit of these early payments as tax deductions. He might, therefore, prefer a lease calling for high rental in the early years to either a lease at a uniform rental or a mortgage calling for large early payments of principal. This might be entirely satisfactory to the financial institution provided that the amounts which it would receive, whatever they might be called, would be sufficient to enable it to recoup its investment with interest at the rate of return which it is prepared to accept.

If we assume an interest rate of 5%, it is easy to work out a plan with the aid of interest tables. The present value at the beginning of a thirty-year period of $1 a year rental for a ten-year period is $7.72 for the first ten years, $4.74 for the second and $2.91 for the third, making $15.37 for the thirty years' rental. Thus the present value is approximately the same whether the rental is (a) $100,000 throughout, or (b) $130,000; $80,000; $53,000 for the three ten-year periods, or (c) $60,000; $100,000; $206,000. More marked variations of rental are possible, e. g. $150,000; $75,000; $8,000. If we assume a value for the property at the end of the lease of $100,000, and the corporation agrees to pay that sum, the present value of the sum is $23,000 which may be added to $1,537,000 that represents the present value of the rentals to make a total of $1,560,000 to be advanced by the financial institution for the rights to be received by it.

If a financial institution enters into a lease in any one of these forms it should, and doubtless would, treat its income as being five per cent on its investment from year to year, rather than the amount received by it as "rental."

But, if the manufacturer followed the same accounting procedure, he would lose the benefit of the method adopted. He will claim that the rentals fixed are objective evidence upon which the charge against income from year to year should be determined.

Going a step further, a corporation may by purchase, sale and lease-back, in effect, secure an income deduction for accelerated depreciation or amortization of intangibles.

Thus, the question is raised, which I suggested in my recent monograph, whether the need is for objective evidence, or for objective weighing of evidence.

Accounting Research Bulletin No. 38 is sound as far as it goes, but cautious and tentative. It does not deal with the question where the rental should appear in the accounts – under cost of sales, fixed charges or elsewhere.

The problem of pensions is of far greater importance and presents difficult features.

Upon this subject, I said in my monograph:

"The costs which are chargeable against past revenues but may not be defrayed until a date far in the future have not hitherto been of major importance. They have included such items as costs arising out of guarantees of past sales, allowances on containers to be returned, etc.

"In recent years, however, the rapid spread of pension systems has made this class of costs an important and troublesome problem in income determination. The difficulties have been mitigated and a reasonably satisfactory treatment of the costs has been made possible by exceptionally favorable treatment of them in income tax accounting, which was granted on the broad ground that the extension of private pension systems in industry was socially desirable.

"It has become accepted practice to charge the pension liability in respect of service prior to the institution of the system over a period of years (ten or more) beginning with the year of institution. (Cf. Accounting Research Bulletin No. 36)

"It is not suggested that the costs of the past service pensions are naturally attributable to the period over which they are to be distributed, but if the cost is charged against income retained in the past (earned surplus) it does not appear in the income account of any year, and charging the cost wholly against the revenue of the year of institution is open to objection on both theoretical and practical grounds.

"If prices should continue to rise, there is likely to be a demand for increase in pensions, including those based on past service. Just as depreciation provisions based on past prices become in such circumstances inadequate for the maintenance of plant, so pension provisions will become inadequate for the intended maintenance of the workers.

"The problem thus created are of far reaching importance and call for more extended consideration than can be given to them here." (p. 34)

Attention may again be called to Accounting Research Bulletin No. 28 (July 1947) in which the Committee took the position that provisions should not be made out of revenues in determining income "in amounts not determined on the basis of any reasonable estimates of costs or losses."

In other bulletins, such as Accounting Research Bulletin No. 33, the Committee has indicated the provisions fall in this category if the amounts thereof are not determinable on the basis of objective evidence.

The contracts entered into with Unions, first in the Coal industry, and quite recently in the Steel and other industries, raise perhaps a broad question of concepts of income rather than a narrower one of implementing an accepted concept.

When a corporation creates a pension scheme and funds the "past service" liability thereunder, clearly the liability must be recognized on its books and a corresponding charge becomes necessary. The rule that this cost may be charged against revenue either immediately or over a period of years, but may not be charged to retained income (earned surplus) is difficult to justify on theoretical grounds, though it has much support in practical considerations.

Accounting Research Bulletin No. 36 takes the position that though the measure of the cost is service in the past, the benefit is to be received in the future. But on the benefit theory the charge of the whole sum against a single year could not be justified. Such a charge is apparently approved on the ground that the obligation was created in the year and has no demonstrated residual value at the end thereof which ought to be carried forward. Justification of the carry forward and distribution over a series of years is found partly in the notion of "distortion" and partly in the assumption that the benefits will extend over a considerable, though not readily measurable, period. The benefits contemplated are reduced turnover, better labor relations, and the like.

In the case of the Coal industry, the corporations assumed an obligation to make determinable payments annually, but not to pay specific pensions to individuals. In this case it has not, I believe, been considered necessary to take up on the books anything except the annual payments made.

In the Steel case, some companies have had funded pension funds and others unfunded voluntary schemes that could, in theory at least, be terminated at any time with no liability except that in respect of pensions already granted, which liability is fully provided for. The recent contracts call for the grant to workers having certain qualifications of age and service who may retire during the term of the contract, of pensions at rates higher than those granted in the past, the amount being dependent in part on the amount receivable by the worker as social security payments. A highly significant feature of the contracts is that the corporations may terminate the grant of pensions at a date earlier than that fixed for the final expiration of the contract, and that if it does so, the Union may terminate the contract.

The obligation is to the Unions, or the workers collectively, the collective obligation being reduced as a pension is granted to an individual. The benefit received is the collective agreement to work (qualified, not absolute) which may be ended by the Union if the corporation decides to discontinue the grant of pensions at the time at which this becomes permissible. The fact that the Unions were prepared to make such a contract is a clear indication that they are confident of their ability to enforce the continuance of pensions as a condition of their members continuing to work. Managements probably have no expectations of the aggregate pensions receivable by labor being reduced unless economic conditions take a serious turn for the worse. But the incidence may well be changed.

This analysis seems to lead to the conclusion that the benefit secured by the cost incurred under the contract is the agreement to work and that this cost should be charged over the expected duration of the benefits which, until there is evidence to the contrary, may be assumed to be the term of the contract. At its expiration a new contract will be made in the light of conditions then existing. There would seem to be no obligation to fund more than the liability under the present contract. The case is not unlike that of a lease of property which is subject to extension at a rental to be fixed in a prescribed manner at the expiration of the first term.

It may be suggested that accounting should proceed on the assumption that new pension contracts not less favorable to labor will be entered into when earlier contracts expire. It would, however, seem logical that the pension burden should before long be assumed by the nation as the Steel Wage Board contemplated; in that event the cost to the corporation would take the form of taxes.

The conclusion that has been reached is supported by consideration of the fact that the amount of pensions is dependent in part on the amount of social security payments, and by the lack of any basis for estimating the "past service" benefit per dollar of pension to be granted with even an approach to accuracy.

The question arises how the case should be treated in which the corporation, in order to secure tax deductions or for other reasons, undertakes to fund an expected past service liability not yet contractually incurred by payments to a trustee which will not be recoverable by it in any event. It might be argued that such action would create a deferred charge, to the extent that the funding payments might exceed the charge against revenue that would have been required if no funding had taken place. But the soundness of this procedure might be questioned, and it would seem to be contrary to the provisions of Accounting Research Bulletin No. 36. If the nation should assume the full burden on the grounds that the public in the end bears the cost even if the corporation bears it initially, any funds created by payments allowed for tax purposes would doubtless be taken over by the government.

The whole subject calls for intensive study.

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