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Comparative Accounting Concepts: A Tower of Babel

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In the industrialized nations, and probably in those not industrialized, the term "assembly line" represents a more or less uniform concept. The same uniformity is found in other terms connected with business events. But while the business events are universally understood, the language which records and expresses those events, accounting,[1] has been divided into so many dialects that it is often difficult to remember that only one language is involved. Just as each nation has its own tongue, so also does it have its own theory of accounting.

This diversity is peculiar in light of the current magnitude of international trade. When corporations of different nations compete in the same markets, it would seem that some uniform ideas concerning how to measure success in such competition should appear. To date that has not been the case.

This diversity is even more peculiar if the suggested uses and benefits of international corporations are taken seriously. For example, Drucker argues that the world economy needs a producing and distributing institution which is not national in either operations or outlook because only such an institution can transcend national prejudices and so defend the interests of the total world economy against the narrower interests of its members.[2] But assuming that we shall have such institutions, it will be necessary, when funds are solicited by them, to be able to decide which of them best defend global interests.

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[1] P. MASON, S. DAVIDSON AND J. SCHINDLER, FUNDAMENTALS OF ACCOUNTING 1 (4th ed. 1959).

[2] P. DRUCKER, THE AGE OF DISCONTINUITY 91 (1968).

The world economy is an economic unit and since profit, while not the sole criterion, is at least a major indicator of economic success, disclosure of profits will have to be made to potential investors. At that time, if the investors are also multi-national, the corporations will have to publish separate statements for the countries involved, unless there has been international agreement on certain fundamentals concerning income accounting. The latter alternative is preferable by far, but there has not been much progress in that direction to date. Mueller is correct in writing that "accounting should be the international language of business, but it is more a Tower of Babel. It is as nationalistic in its development and practice as atomic know-how or the competition among flag-carrying airlines."[3]

Differences between countries are made more complex by the frequent lack of uniformity within a single country. In the United States, the concept of net income for financial reporting purposes is not necessarily the same as the concept of net income found in the corporation laws. In the Netherlands, significant differences separate the tax authorities and the accountants at Philips.

No attempt will be made to reconcile the disparate theories which will be discussed hereunder. Only the modest task of explaining the approaches to net income, depreciation and inventory valuation found in the United States, France, Germany and the Netherlands will be undertaken. This discussion will not include requirements imposed by stock exchanges or regulatory commissions. It will be limited to the views of accountants and their societies, and to the tax, corporation and other relevant laws. In both France and Germany there are fewer corporations than limited liability companies, *i.e.,* S.A.R.L.'s and GmbH's. But if their number is less, the thought which has gone into accounting principles for corporations is greater, and for that reason they and not their more numerous relatives were chosen.

Income

United States:

For an accountant, income is determined by matching or assigning expenses to revenues. If a positive difference remains, there is income or profit. If there is a negative difference, if assigned expenses exceed revenues, there is a loss.

Implicit in this approach is the realization doctrine, or the idea that expenses and revenues should not be recorded until they come into exis-

[3] G. Mueller, *International Experience With Uniform Accounting,* 30 LAW AND CONTEMP. PROB. 850, 856 (1965).

tence. This doctrine raises the problem of determining the period for which expenses or revenues will be assigned. For example, if a firm enters into a long-term construction contract so that work will extend over more than one accounting period, expenses and revenues arising from this contract must nevertheless be accounted for in interim financial statements. That is, they must be assigned, and income, or as more commonly said, profit or loss, determined.

It would be possible to wait until completion before determining the income arising from the contract. Such a procedure, known as the completed-contract method, has the advantage of certainty. On the other hand, it does not reflect the true performance of the interim period. An alternative procedure, the percentage-of-completion method, recognizes periodic income, but has the disadvantage of being uncertain.[4] It is obvious that income for a single period will vary with the method used.

This same problem of periodicity is found running the length of the income statement. It is ubiquitous because it conflicts with another basic postulate of accounting, *viz.*, continuity of activity, or the "going-concern" concept. In other words, for accounting purposes, it is assumed that the business entity will continue in existence. While this assumption may be "largely one of convenience,"[5] it roughly represents experience. But it affects periodic determination of income.

> In so far as the business enterprise is a continuous stream of activities, with those of the moment conditioned by those of the past and in turn conditioning those of the future, the process of breaking the stream into fiscal segments, for each of which reports are prepared, severs many real connections and tends to give a specious color of immediate reliability to data which in substantial measure depend on the course of future events.[6]

Recognizing the problem, the AICPA undercut somewhat the conceptual validity of any periodic income statement by warning that "profits are not fundamentally the result of operations during any short period of time."[7] This attitude, as will be explained more fully *infra*, led to practices that left statements of German companies almost useless until parliament made sweeping reforms. The United States has escaped the consequences of the limits of this logic.

For purposes of American taxes, income represents much the same

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[4] The Committee on Accounting Procedure, AICPA, ACCOUNTING RESEARCH BULLETIN NO. 45 (October, 1955), recommends the percentage of completion method when estimates of cost and degree of completion are "reasonably dependable." *See* Escott v. BarChris, 283 F.Supp. 643 (1968) for a partially unsuccessful challenge of this method.

[5] W. A. PATON AND A. C. LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 9 (1940).

[6] *Ibid.*, 9-10.

[7] RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS 59 (1961).

concept as it does in financial accounting. Gross income,[8] from which certain items are specifically excluded,[9] is matched against the expenses, *i.e.* deductions,[10] for the period. The result is net, or taxable, income.[11] In the United States, the realization doctrine is a basic tenet of income for tax purposes.[12] The requirement of yearly tax returns indicates that the difficulties of periodicity are also present.

At least superficially, the concept of taxable income and income for purposes of financial accounting, thus give the impression of being identical. But they are not. "The former has a macro purpose. Its objective is revenue collection consistent with established national policies. . . . By contrast, financial accounting has an orientation to the individual business entity . . ."[13]

Tax legislation must be viewed in light of the social policies it is intended to fulfill, *e.g.*, encouragement of small business, equalization of income, etc. Financial accounting, however, is intended to give a measure of the success of a firm in its fight for survival. Indeed, for financial purposes, income taxes are only one more cost of doing business. Because firms try to minimize their expenses, there will almost invariably be an attempt to keep taxable income, as opposed to financial income, as low as possible. The use of accelerated depreciation for tax purposes, and another method for financial purposes, illustrates this attitude and underscores the differences between the concepts.

Yet a third concept of income exists in the United States, and it is found in the corporation laws. Under these, instead of periodically matching revenues and expenses, stated capital is often subtracted from net assets in determining whether a surplus from which dividends may be paid exists.[14] A variation of this approach is to subtract liabilities from assets.[15] In both cases the concept is the same.

This concept was derived from the trust fund doctrine which provided that "dividends could not be paid out of *capital* but only out of *profits*. . . (I)t was implicitly assumed in all the legal formulations that the two tests were identical: if there were no profits then of necessity a distribution would be out of capital (or would 'impair' capital) and vice

[8] I.R.C. § 61.
[9] I.R.C. §§ 101-23.
[10] I.R.C. §§ 161-82.
[11] I.R.C. § 63.
[12] Eisner v. Macomber, 252 U.S. 189 (1920).
[13] GERHARD MUELLER, INTERNATIONAL ACCOUNTING 50 (1967).
[14] *E.g.*, N.Y.B.C.L. § 510(b) (McKinney, 1963); Del. Gen. Corp. Law § 170(a)(1) (1935). The 1967 amendment to the Delaware statute is a change in form only. The substance of the old law remains.
[15] N.C. Gen. Stat. § 55-50(c)(2) (1965).

versa. From this it appeared in law that a surplus of net assets indicated the existence of net profits."[16]

At this point, a short comment on *Randall v. Bailey*[17] is required. The balance sheet approach to funds available for dividends was retained in that case, but by upholding, against the trustee in bankruptcy, the power of the directors to pay dividends out of surplus created through revaluation of assets, New York broke with the recognition doctrine which has been almost universal in corporation law. The theory behind revaluation was not as fully developed in that case as it is in the Netherlands, so a discussion of this method will be pretermitted until the section concerning Dutch practices is reached.

Although the trust fund doctrine is in questionable standing, its progeny is still strong. But, though strong, it has a viable competitor in the nimble dividend rule.

As long as the preferred shareholders' preferences are maintained, and the distribution will not cause insolvency, nimble dividends[18] may be paid in any fiscal year for which there is income regardless of what remainder results from the subtraction of stated capital from assets. This approach to dividends is a return to the matching of revenues and expenses for a period. As such, it is more in accord with the concepts of income found in tax law and financial accounting.

France:

Income for corporate purposes is defined by Article 344 of the Business Associations Law[19] as follows:

> Net income consists of receipts for the fiscal year reduced by general expenses and other charges which include depreciation and reserves.

This definition presents no difficulties to Americans since it contains the doctrines of assigning revenues and expenses, realization and periodicity. But the Law is only half of the story. The rest is found in the tax laws.

The General Tax Law defines income as the difference between net assets at the beginning and end of the year, diminished by additions to capital and increased by distributions.[20] This provision came into French law in 1941 as an almost literal translation of § 4(1) of the German Income

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[16] W. Hackney, *Accounting Principles in Corporation Law*, 30 LAW AND CONTEMP. PROB. 790, 801 (1965).

[17] 288 N.Y. 280, 43 N.E.2d 43 (1942).

[18] *E.g.*, Del. Gen. Corp. Law § 170(a)(2) (1935); MBCA alternative § 40(a).

[19] Law No. 66-537 of 24 July 1966. J.O. 26. 7. 66.

[20] Code Général des Impots (C.G.I.) Art. 38(2).

Tax Law.[21] It is not surprising that it thus represents the German net worth comparison approach to income, which is similar to the approach seen in the American corporation laws, and differs from the approach defined in the Business Association Law.

Reconciliation of the two views comes when the tax return is prepared, since all enterprises except those to which special regulations apply—*e.g.*, banks and insurance companies—are required to file their returns with schedules prepared according to standard forms which are substantially the same as those found in the French uniform system of accounts, the *Plan Comptable Général*. The mechanics of determining taxable income require starting with income as defined in the Business Associations Law, and thereafter adjusting certain accounts, *e.g.*, dividends, which might be excludable, long-term capital gains, which may be taxed at a rate of 10% instead of the normal 50%, etc.[22]

Germany:

Under the leadership of its most renowned theoretician, Eugen Schmalenbach, German accounting has denied almost completely the validity of periodic income accounting. An individual accounting period, it is argued, "... cannot be considered independent, and period reporting must be based upon inter-period relationships. Schmalenbach emphasizes also, that period accounting can never arrive at a true income measurement; only total accounting can. Thus, every day accounting for periodic reporting can, at the most, be approximating."[23] In short, only after the business entity has ceased to exist can income be truly measured. This theory is not unknown in the United States;[24] but in Germany it has been accepted with a passion which, coupled with the idea of protecting creditors, prior to the new Share Company Law, resulted in financial reports of dubious value.

For example, reserves were frequently used and vigorously defended:

> If (net profit) is incorrectly overstated, because, let us say, some risk is not adequately provided for, there ensues the danger that a portion of the capital which is supposed to serve as protection for creditors will be distributed to the shareholders as profit... If the non-existence of a contingency cannot be absolutely determined, then in the interest of protecting the creditors, it must be assumed that such a contingency exists.[25]

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[21] INTERNATIONAL BUREAU FOR FISCAL DOCUMENTATION, CORPORATE TAXATION IN THE COMMON MARKET I-B: 15 (1968).

[22] *See* Decree No. 65-968 of 28 October 1965; PRICE WATERHOUSE & CO., INFORMATION GUIDE FOR DOING BUSINESS IN FRANCE 14, 25-27 (1967).

[23] A. van Seventer, The Theory of the Dualistic Balance Sheet 180, 1966 (unpublished thesis in U. of Michigan Business School Library).

[24] *See* note 7 *supra*, and accompanying text.

[25] Johannes Semler, Jr., *The German Accountants' Approach to Safeguarding Investors and Creditors Interests*, Technical Paper, Eighth International Congress of Accountants,

The assumption is clearly made that the existence *vel non* of certain contingencies cannot be determined, because at any moment, short of the demise of the firm, the future is uncertain. Rephrased, any interim accounting rests on questionable foundations.

From the use of reserves to the use of hidden reserves was an easy step: "In many branches of business the calendar year is much too short a period to allow a fairly exact profit and loss canculation. In this case hidden reserves are often useful to permit reliable average calculations for the longer period of the enterprise cycle on the basis of the annual calculation."[26] The acceptance of that argument made it dangerous for the outside investor, as opposed to the large creditor who would be privy to more accurate information, to rely on financial statements.

A second cause of hidden reserves was the judicial interpretation of the old Law. According to a decision of the Federal Supreme Court any stockholder could demand that all reported income be distributed as dividends.[27] In terms of both creditor protection and business survival, it was therefore considered to be good policy to try to hide income.

The new Share Company Law[28] has hopefully changed prior practices. To the extent that certain surety arrangements and legal or business dealings with related German corporations do not have to be disclosed if disclosure would substantially injure the firms involved, the new Law still does not require the reporting of all of what would be the material facts in the United States.[29] Nevertheless, the use of hidden reserves has been strictly limited.[30] The attention paid to asset[31] and liability[32] valuations reinforces this policy of using reporting as protection for both creditors and shareholders. Creditors are protected further by the provision prohibiting dividends until after the legal reserve amounts to 10% of stated capital.[33] If disclosure does not meet the minimum requirements, auditors may be appointed by a court[34] or the statements may be declared void.[35]

Also changed is the rule allowing shareholders to demand that all income

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1962, Session "N", p. 5. Quoted in E. J. Pavlock, A Comparison of Periodic Income Reporting Among the United States, West Germany, The Netherlands, and Sweden, 119, 1965 (unpublished thesis in U. of Michigan Business School Library).

[26] H. ADLER, W. DURING AND K. SCHMALTZ, RECHNUNGSLEGUNG UND PRÜFUNG DER AKTIENGESELLSCHAFT (3te Auflage, 1957), quoted in G. MUELLER, ACCOUNTING PRACTICES IN WEST GERMANY 12 (1964).

[27] 10 NJW 588 (1957).

[28] Aktiengesetz vom 6 Sept. 1965; Bundesgesetzblatt, 1965, I. 1089.

[29] Art. 160(4).

[30] Arts. 150, 152, 156(4).

[31] Arts. 153-155.

[32] Art. 156.

[33] Art. 233.

[34] Art. 258(1).

[35] Arts. 256-257.

be paid out. If the shareholders approve the annual account, the charter may provide that amounts not in excess of one half of the annual income may be transferred into free reserves.[36] In the more frequent case in which the executive board and the supervisory council pass on the annual statement, those bodies may also transfer up to one half of income to free reserves. More than one half may be transferred if the charter so allows, as long as free reserves would not afterwards exceed one half of stated capital.[37]

More thorough disclosure will result from these statutory changes. But it should not be thought that accounting theory has been changed, except to the extent that German accountants are no longer able to carry their views on the value of periodic reports as far as they could before.

The German concept of income is still that of physical maintenance; that is, emphasis is not on the shareholders and their interest, but on the firm organized as a producing unit. "Instead of the formula G-W-G (Geld-Ware-Geld) (Money-Commodity-Money), Ware-Geld-Ware applies, reflecting the nature of the economic production of the enterprise."[38]

This theory is illustrated by the income statement set forth in the Law.[39] To sales is added the change in inventory in order to show ". . . whether or not management has been successful in applying the production factors placed at its disposal towards a profitable end."[40] It is due to this theory that the sum of the figures is called *Gesamtleistung* (aggregate performance) rather than something more revenue oriented.

As is true in the other countries, the German concept of taxable income is not the same as the German concept of accounting income. The Income Tax Law defines income as:

> . . . the difference in amount between the business assets at the close of the business year and the business assets at the close of the preceding business year, increased by the value of the receipts and decreased by the amount of the capital invested.[41]

As would be expected of a system in which income is directly affected

[36] Art. 58(1).

[37] Art. 58(2).

[38] van Seventer, *supra*, 262.

[39] Art. 157.

[40] R. J. Niehus, *Tax-Free Stock Dividends and the New Model Income Statement for German Corporations*, 36 THE ACCOUNTING REVIEW 259, 262 (April, 1961). For purposes of this discussion it is assumed that the corporation is sufficiently large so that § 157(4) (allowing the first five items on the income statement, *i.e.*, sales, changes in inventory, other performance, total performance, and expenses for materials, to be shown together), is not applicable.

[41] EStG, Art. 4(1).

by the valuation of assets and liabilities, the tax laws give detailed rules for valuation.[42]

Reconciliation of the two income figures begins, as was true in France, with the statement prepared for commercial purposes. To that statement are made the adjustments required by tax law.

The Netherlands:

Dutch corporations face a minimum of legally imposed accounting requirements. At present, the only significant statute is found in the Commercial Code, and requires the annual preparation of a balance sheet and an income statement.[43] The content of the income statement is not specified. Concerning the balance sheet, the Code lists eleven items which must be shown separately[44] and requires an explanation of the valuation method used.

With so few constraints imposed upon them, Dutch accountants have succeeded in developing their skills in accordance with the needs of sound theory and "sound business practices." This development has been influenced most strongly by the Netherlands Institute of Accountants and by the work of Th. Limperg.

The business entity and its survival are the focal points of Dutch accounting theory. If the firm is successful, its wealth will increase. But since wealth is measured in terms of a currency, and currencies tend to be unstable,[45] if the firm's wealth is to be measured correctly, the effect of

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[42] For basis *see* EStG, Art. 6; for depreciation *see* Art. 7.

[43] Art. 42.

[44] (1) Cash on hand and callable money claims; (2) investments in, and amounts receivable from, other companies; (3) securities quoted on an exchange and not included in (2); (4) securities not quoted and not included in (2); (5) accounts receivable not included in (1) or (2); (6) inventory; (7) tangible long-term assets; (8) intangible assets; (9) deferred income and advance payments received; (10) prepaid expenses and deferred charges; (11) any unpaid balance on subscriptions to the corporation's stock.

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	Indexes of Value of Money			Annual Rates of Depreciation	
	1957	1962	1967	1957-1967	1966-1967
United States	100	93	84	1.7	2.7
Luxembourg	100	97	84	1.8	2.1
Belgium	100	95	80	2.2	2.8
Germany	100	95	80	2.2	1.4
Netherlands	100	92	73	3.1	2.8
Italy	100	89	71	3.4	3.1
France	100	73	62	4.7	2.6

Source: First National City Bank, MONTHLY ECONOMIC LETTER 95 (August, 1968).

price-level changes must be accounted for. The Dutch accomplish this task by using replacement values.[46]

According to this theory, income is the difference between revenues and the replacement value of the goods sold, plus all other expenses incurred in producing these goods. The objective is to recognize no income unless the capital invested in the firm has been maintained, that is, unless the firm's purchasing power at the end of a period is greater than it was at the beginning of the period. The result is that the figure shown as income represents an amount which can be spent without altering the original economic position of the firm. "Profit is therefore the income which may be spent without trespassing on the capital of the business, which is the source of income. The fruit may be picked but the tree may not be felled."[47] This is thought to be a particularly happy result in the area of dividends since there is a danger, when historical costs are used, that the pay-out will come not only from income, but also from the funds required for replacements and therefore for the continuity of the firm.[48]

The major consequences of applying replacement value theory are three:

1) During periods of rising prices profits are lower than they otherwise would be;

2) Net worth is larger so the ratio of profit to net worth is less favorable;

3) Even if, after distribution of dividends, the position of the firm using replacement value is the same as it would be if historical costs were used, the position is achieved under historical methods by means of a higher income and a larger retained earnings which superficially makes the firm's position look better.[49]

Returning for a moment to the issue involved in *Randall v. Bailey*,[50] the break in that case from the recognition doctrine does not lead to the theory used by the Dutch. It is true that the Dutch write up the values of their assets, but when that is done there is also an increase in both the accumulated depreciation account and the depreciation expense account. An increase in capital surplus will result, but it will be of a lower magnitude than it would have been if depreciation charges had not also been increased. Indeed, merely enlarging the book value of the assets without also increasing the depreciation accounts is contrary to Dutch theory, since

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[46] Not all Dutch firms use replacement values. Since no method is prescribed by law, each company is free to use the method it prefers. Firms which do not use replacement values, use accounting procedures similar to those employed in the United States.

[47] A. Goudeket, *How Inflation is Being Recognized in Financial Statements in the Netherlands*, 94 J. OF ACCOUNTANCY 448, 448-9 (October, 1952).

[48] A. Goudeket, *An Application of Replacement Value Theory*, 110 J. OF ACCOUNTANCY 37, 45 (July 1960).

[49] *Ibid.*, at 47.

[50] *See supra*, note 17 and accompanying text.

capital surplus would then be shown at too high a figure.[51]

As should be expected, replacement value theory is not permitted for purposes of determining taxable income.[52] The macro approach of the tax authorities is again in conflict with the micro approach of the firm.

The Dutch tax definition of income is similar to that used in the United States. In the Netherlands it is defined as follows:

> Business income is the sum of all profits or gains of whatever nature of description realized by the conduct of the business enterprise.[53]

In America, gross taxable income is "... all income from whatever source derived ..."[54] But the similarity of definitions hides distinctions in application. For example, the Dutch do not differentiate between ordinary income and capital gains.

For tax purposes, income, as in France and Germany, is computed by the net worth method. If income on the financial statements does not match taxable account, the difference may be reconciled by using a deferred tax-liability account.

Depreciation

United States:

When a firm purchases a fixed asset, it is in effect prepaying for services to be received in the future. The recognition doctrine requires that the prepayment be entered at the cost of the asset at the time of the purchase. The majority opinion in the United States is that the measurement of the expiration of these services must also be based on the purchase price.[55]

To avoid confusion, it should be remembered that two problems are involved in measuring expiration. The first concerns the rate at which the services are consumed; the second, the dollar figure which will be assigned to the consumption. To illustrate, if a machine is purchased for $X and will be capable of operating for exactly 10 years, at the end of which time it will have no salvage value, the rate of depreciation each year will be X/10. But after the rate is known, the problem of determining the value of X remains.

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[51] It is the position of the AICPA that if assets are written up, depreciation is to be computed on the stepped-up amounts. RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS 73 (1961).

[52] ARTHUR ANDERSEN & CO., TAX AND TRADE GUIDE THE NETHERLANDS 31 (1965). *See also* Dutch decisions B 2110 and B 2988 summarized in Foreign Tax Law Assoc. Inc., NETHERLANDS INCOME TAX SERVICE 15 (1968).

[53] Individual Income Tax Law of 1964, Art. 7.

[54] I.R.C. § 61.

[55] Opinions of the Accounting Principles Board of the AICPA, *Opinion No. 1*, 42 (October 1965); Committee on Concepts and Standards—Long-Lived Assets, American Accounting Association, *Accounting for Land, Buildings and Equipment, Supplementary Statement No. 1*, 39 ACCOUNTING REV. 693, 698 (1964).

There is little practical difficulty with the first problem, because the accelerated methods of allocation have been found to be "systematic and rational."[56] The argument focuses on the second problem, that is as to whether the services consumed should be valued according to the asset's original cost, or according to the present cost of buying an identical asset.

The issue will be less confused if it is understood what depreciation is and what it is not. It is not a source of funds. Firms cannot finance expansion or replacement out of depreciation. It is true that if revenues are sufficient to cover all expenses, an amount of cash equal to the depreciation expense will remain. But if there are no revenues, and the only expense is depreciation, there will be no cash generated. This example illustrates the role of depreciation as an expense identical in nature to all other expenses.

When the period's income statement is prepared, if employees received $X as wages, that amount is entered as an expense since it represents a cost of doing business during the period. Similarly, if 1/10 of a machine is used up, that use also represents a cost of doing business. But if the machine was purchased five years ago and the purchasing power of a dollar has since declined, by putting the employees' wages in the same list of expenses as the depreciation, two different items will be equated. During periods of inflation or deflation, a dollar does not maintain the same relative value. Properly to report the results of a firm's activity during any period, the values represented by the dollar figures must be stabilized, that is, they must be equated. To equate them, the recorded value of the asset should be, assuming inflation exists, adjusted to reflect present values. With the rate of depreciation remaining constant, a change in the book value will fix the required equivalency.

The defense of revaluation should not rest on the fact that replacement costs have increased. Such a defense is open to the objection that an asset of identical technological development will not be substituted for the asset currently being depreciated. Rather, the proper defense of this method is that it alone fulfills the requirements of an income statement, since only it takes cognizance of the true, *i.e.*, present costs of doing business.[57]

For American tax purposes the question is closed. The basis of property is its cost.[58] The tax authorities do, however, allow accelerated as well as straight-line rates of depreciation,[59] these rates being applied to the adjusted basis of the asset.[60]

[56] Committee on Accounting Procedure, AICPA, ACCOUNTING RESEARCH BULLETIN No. 44, 1-A (July, 1958).

[57] W. A. Paton and W. A. Paton, Jr., *Asset Accounting;* reprinted in ACCOUNTANTS' HANDBOOK 18.25 (4th ed. 1965).

[58] I.R.C. § 1012.

[59] I.R.C. § 167.

[60] I.R.C. § 167(g).

Corporation law in the United States has also generally accepted the cost basis. Although North Carolina has statutorily shifted to a fair present value basis for determining whether dividends may be paid,[61] or whether a corporation may purchase or redeem its stock,[62] there is no general American trend away from the old rule. That is unfortunate since such a change would prevent at least one type of abuse.

In *Zahn v. Transamerica Corp.*[63] Axton-Fisher Tobacco Company was carrying its principal asset, leaf tobacco, on its books at cost, $6,361,981. Transamerica, which had taken control of Axton-Fisher, knew that the market value of the tobacco was approximately $20,000,000. Transamerica had the outsiders' stock redeemed, liquidated the assets and pocketed the profit. Although Transamerica was not allowed to keep its gain, this case underscores the danger of allowing a difference to exist between book and market values. That the assets involved in this case were inventory and not fixed is irrelevant. The same abuse is possible regardless of the type of asset.

France:

The Business Associations Law gives almost no rules on the problem of asset valuation. Only continuity of method[64] and accuracy[65] are required. To be accurate, depreciation must be recorded even if revenues are non-existent or insufficient to cover expenses. Apparently, to compensate for the lack of guidance in the Law, a later decree incorporated into the Law the accounting rules required for tax purposes.[66] France has thus achieved uniformity.

For tax purposes, basis is original cost (*valeur d' origine*) which includes actual price (*coût réel d'achat*) plus ancillary expenses.[67] The tax laws also specify the permissible rates of depreciation. Straight-line is always allowed. For certain assets, *e.g.*, plant and equipment used in manufacturing, accelerated depreciation is allowed if the assets were purchased new, and have a useful life of at least three years. Special provisions apply to buildings used for scientific research, and allow half the cost to be depreciated in the first year.[68] Revaluations were at one time permitted in

[61] Gen. Stat., § 55-50(c)(2), (1965).
[62] Gen. Stat., § 55-52(e)(2), (1965).
[63] 162 F.2d 36 (CA-3d Cir. 1947).
[64] Art. 341(1).
[65] Art. 342(1).
[66] *See* Decree No. 67-236 of 23 March 1967, Art. 295.
[67] Decree No. 65-968 of 28 October 1965, Art. 4.
[68] *See* PRICE WATERHOUSE & CO., INFORMATION GUIDE FOR DOING BUSINESS IN FRANCE 32-33 (1967).

France, but are thought no longer to be necessary since accelerated depreciation was made available.

Germany:

The Share Company Law of 1965 provides that fixed assets are to be carried at purchase or production costs less depreciation.[69] If the assets have a limited useful life, depreciation must be taken in a systematic way according to sound accounting principles.[70] Regardless of whether assets have a limited useful life, if depreciation for tax purposes exceeds depreciation for financial accounting, the lower valuation allowed for tax purposes must, according to tax law, also be used for financial reporting, and so the Share Company Law permits, in order to cover this situation, unscheduled value adjustments.[71]

The tax laws require cost to be used as a basis. Because assets which were a part of the business during the preceding year cannot appear in the balance sheet at a figure higher than that shown for the prior year, revaluation is impossible.[72] Depreciation rates are not fixed by law, which requires only that depreciation be measured according to life expectancies. In practice, however, a great deal of standardization has been achieved through the cooperation of the tax authorities and the industrial organizations.

Accelerated depreciation is permitted for movable assets, *i.e.*, assets other than buildings, etc. Other assets must be depreciated on a straight-line basis.[73] While firms may switch from accelerated to straight-line, they may not switch from straight-line to accelerated.[74]

In fixing the depreciation rates, the corporation need not take into account the expected salvage values. Since profits on the sale of fixed assets are taxable at the same rate as ordinary income, this factor is of minor significance.

Netherlands:

If replacement values are used in financial accounting, depreciation is usually determined on a straight-line basis. Even when historical costs are used straight-line is the most prevalent method of determining depreciation.[75]

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[69] Art. 153(1).

[70] Art. 154(1).

[71] Art. 154(2). *See also* BAUMBACH-HUECK, AKTIENGESETZ paras. 153-156, n. 16 (13th ed. 1968).

[72] EStG Art. 6(1).

[73] EStG Art. 7(1).

[74] EStG Art. 7(3).

[75] S. Davidson and John Kohlmeier, *A Measure of the Impact of Some Foreign Accounting Principles*, 4 J. OF ACCOUNTING RESEARCH 183, 192 (Autumn, 1966).

In computing depreciation for income taxes, historic cost must serve as the base.[76] Depreciation on the basis of replacement cost is prohibited.[77] As for methods of depreciation, all save accelerated are permitted so long as they are thought appropriate in business, and correspond to the actual nature of depreciation. Different assets or different groups of assets may be depreciated on the basis of different methods, but the requirement of consistency usually prohibits a change in methods.[78]

Accelerated depreciation was suspended by Ministerial decree for all assets purchased (ordered or received) after 31 January 1964. It has been reinstated for buildings ordered or acquired on or after 12 October 1967, unless the buildings are located in the area known as "Randstad Holland," *i.e.*, the provinces of Utrecht, South Holland and most of North Holland.[79]

Inventories

United States:

The term inventory applies to three classes of goods: those ready for sale in the ordinary course of business; those in some stage of production, short of completion, in preparation for sale; those not yet, but soon to be used in production in preparation for sale. Reference is also made to these

[76] Corporation Income Tax Law, Art. 13(2)(b).

[77] *See* note 52.

[78] INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *supra*, I-F:16.

[79] *Ibid.*, I-F: 18. Summary of Depreciation Rates Acceptable for Tax Purposes:

Straight-Line

	France	Germany	Netherlands	U.S.
Factory Buildings	5%	2-4%		45 years
Office Buildings	4%	2-2½%		45 years
Plant & Equipment	10-20%	10%	No Specified Rates	12 years
Office Equipment	10-20%	10-33⅓%		10 years
Vehicles	20-25%	20-33⅓%		3-9 years

Accelerated

France:	1½ times straight-line if useful life is 3 or 4 years. twice straight-line if useful life is 5 or 6 years. 2½ times straight-line if useful life is more than 6 years.
Germany:	twice straight-line but not more than 20%.
United States:	Declining balance at any rate not more than twice that which would result under straightline. Sum-of-the-years-digits. Any other consistent method which, during the first ⅔ of the asset's useful life, does not give a total deduction greater than that which would result under declining balance.

Sources: INTERNATIONAL BUREAU FOR FISCAL DOCUMENTATION, *supra*, I-B: 25.
ARTHUR ANDERSEN & CO., TAX AND TRADE GUIDE GERMANY, 27 (1968).
PRICE WATERHOUSE & CO., INFORMATION GUIDE FOR DOING BUSINESS IN THE NETHERLANDS, 14 (1966).
I.R., § 167.
C.C.H., 1969 STANDARD FEDERAL TAX REPORTER, ¶ 1763.

divisions as finished goods, work in process, and raw materials. Depreciable assets are not included as part of inventory.[80]

The purpose of accounting for inventories is to make possible the proper measurement of income by allowing the expenses incurred in the sale of goods to be assigned properly to the resulting revenues.[81] To achieve this purpose, any one of several assumptions concerning the flow of goods through the firm, *e.g.*, LIFO, FIFO, average, is acceptable. In the interest of "conservatism" the valuation of the goods may be subjected to the lower of cost or market test.

In inventory accounting, as elsewhere, cost is the primary basis. As elsewhere, however, this view is under attack.[82] Cost includes more than just the amount paid for the goods. Included in cost are all "the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location."[83] This definition makes direct costing an unacceptable accounting procedure.

The only constraint on the choice of flow methods is that the method chosen must, "under the circumstances," best reflect the periodic income.[84] If LIFO or any other method meets this requirement—although how it can be proved that any such method does or does not meet the requirement when the items in inventory are interchangeable is not clear—that method may be used. In case the goods in inventory should, at the end of the period, be worth less than their cost, generally accepted accounting principles require a departure from their otherwise hallowed demand that cost always be used as a basis.[85] In such a case, inventory value is determined according to market prices, *i.e.*, current replacement cost, with the limitations that market should not be in excess of net realizable value, that is, ordinary selling price less predictable expenses for production and sale, and should not be less than net realizable value reduced by a normal profit margin.[86]

The inconsistency in requiring use of replacement costs when the market falls, but forbidding their use when the market rises, should be obvious. The argument for using this method is that if the goods can be replaced for

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[80] RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS 27 (1961). Statement 1.

[81] *Ibid.*, 28. Statement 2.

[82] Committee on Concepts and Standards—Inventory Measurement, American Accounting Association, *A Discussion of Various Approaches to Inventory Measurement, Supplementary Statement No. 2*, 39 ACCOUNTING REV. 693 (1964).

[83] *Restatement and Revision of Accounting Research Bulletins* 28 (1961). Statement 3.

[84] *Ibid.*, 29. Statement 4.

[85] *Ibid.*, 30. Statement 5. There are cases in which inventories may be shown above cost, *e.g.*, precious metals with a fixed monetary value and little or no marketing costs. *Ibid.*, 34. Statement 9.

[86] *Ibid.*, 31. Statement 6.

less than their original purchase price they will be sold for less than their anticipated selling price, and therefore a reduction in value has occurred which should be recognized as a cost of the current period. If use of this method serves "conservatism" in the current period, an unconservative result appears in the next.

Assuming a cost basis for inventory at the end of the period of $30,000, and a merchandise cost of sales for the period of $20,000, and assuming further that replacement costs have fallen so that the inventory has a present value of $27,000, if lower of cost or market is used, $3,000 is added to the period's merchandise cost of sales, and subtracted from inventory. The effect is to reduce the period's income by $3,000. But the effect on income in the next period is the opposite. Because opening inventory will be $3,000 lower than it otherwise would be, the period will show income $3,000 higher than it would be if cost had been used.[87]

For income taxes, the rules relating to inventories are much the same as those employed in the area of financial accounting. The method chosen must conform as nearly as possible to the best accounting practice in the trade or business, and must also best reflect the period's income:[88]

> It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a tax-payer should be constant from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation. . . .[89]

Cost, and lower of cost or market, are thought to be the most common bases of valuation, and are acceptable for tax purposes.[90] Flow is usually handled on a first-in, first-out basis, but LIFO is permitted.[91] The decision to use LIFO is irrevocable unless the Commissioner of Internal Revenue should require the use of another method, or authorize another method pursuant to a written application.[92] Since the current inflation does not seem to be in any danger of reversing itself, the irrevocability of the election is hardly likely to influence any firm's choice of methods.

The secular nature of inflation argues for the adoption of LIFO. The major attraction of this method is that it permits the use of the cost of the most recently purchased goods which, because prices are rising, should cost more, as a deduction from revenue. The result should be that taxable

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[87] W. A. PATON AND R. L. DIXON, ESSENTIALS OF ACCOUNTING 354-5 (1958), contains the arguments on both sides of the issue, and supplies the example used in the text.

[88] I.R.C. § 471.

[89] I.T. Regs. § 1.471-2(c).

[90] I.R.C. § 427. *See also* I. T. Regs. § 1.472-2.

[91] I.T. Regs. § 1.472-5.

[92] *Id.*

income is lower than it would be if goods purchased earlier, and so theoretically at a lower price, were used to determine cost of sales.

It is interesting that this option is made available by the Internal Revenue Code. It allows a merchant to state his costs in terms of the same kind of dollars which describe his revenue. But the same option is not given to the firm which has invested in depreciable assets. Since inventory generally turns over several times a year, the merchant would be less harmed were he forced to use FIFO than the firm with a large investment in depreciable assets is damaged by the requirement of historic costs.[93]

France:

The Business Associations Law is almost silent on the question of inventories. French practices are therefore determined solely by the *Plan Comptable* and the tax laws.

According to tax laws, inventories are valued at the lower of cost or market. Cost includes both the purchase price and ancillary expenses, including overhead. If exact cost is not known, an average cost based on rate of turnover may be used to determine the value of inventory. Market is defined as probable selling price at the time of closing. If a market price cannot be determined, the probable realizable value may be used. Should the market price fall below cost, a reserve must be created to reflect this difference. Tax laws permit TVA recoverable to be shown either as part of the cost of inventories, or as a separate debit to a short-term receivables account. Because the latter is almost always the method used, the inventories usually appear stated in terms of net amount.[94] As for flow, LIFO is not permitted.

It is possible to delay for up to six years the recognition of income which arises from a 5%-per-year-for two years, or a 10%-in-one-year increase in the market price of inventory. The unit book value of each item in inventory is compared to that item's book value at the end of either of the preceding two years. A tax-free reserve may be created for each item for which more than a 10% increase in value has occurred. The amount of the reserve is determined by multiplying the per-unit increase in excess of 10% by the number of units in stock. The reserve can last for no more than six years but may be maintained that long even if prices fall. If the firm is sold, the reserve is automatically taxable.[95]

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[93] *See* W. A. Paton, *The Depreciation Deduction–A Neglected Aspect*, MICHIGAN BUSINESS REVIEW (November, 1953), reprinted in H. F. Taggart (ed.), PATON ON ACCOUNTING 596-7 (1964).

[94] Decree no. 65-968 of 28 October 1965, Arts. 8, 9, 11. *See also* BUSINESS ASSOCIATION LAW, ART. 342(2).

[95] Law no. 59-472 of 28 December 1959, Art. 32. *See also* Vincent Jolivet, *The Current French Approach to Inventory Price Level Problems*, ACCOUNTING REV. 689 (1964).

Germany:

For financial reporting, Germany uses the lower of cost or market.[96] If a market price is not obtainable, and it is obvious that historic costs are unrealistic, a value is imputed to the inventory. Value in this context means either replacement cost or net realizable amount. If the item to which a value is to be imputed has not yet entered the production process, replacement costs are used. If the item has become work in process, a net realizable figure is used.[97]

If rational business judgment indicates that price fluctuations will soon necessitate an alteration of the value of current assets, or if the tax authorities allow a lower valuation, inventories may be shown at a figure below that which would otherwise be acceptable.[98] If the lower value is used, it may be retained even if the reasons necessitating its use no longer exist.[99]

With respect to flow, "so far as it is in accord with the principles of sound bookkeeping," the Share Company Law permits the use of LIFO, FIFO, or any other assumption.[100] At this point, tax law and corporation law diverge. For tax purposes, with only minor exceptions, weighted average is required.[101] It has been suggested that in light of the greater freedom permitted by the new commercial law, a change in tax policy may be forthcoming.[102]

As was true in France, a tax-free reserve lasting for six years may be established for inventories, if their cost has increased more than 10% in one year. Further, tax free reserves of up to 30% are allowed in order to encourage stockpiling of basic raw materials which are scarce in Germany.[103]

Netherlands:

The Dutch use the lower of cost or market or replacement values in handling inventories for financial purposes. If historic costs are considered, LIFO, FIFO, etc. are used.[104] If replacement values are used, the problem of flow does not arise.

In the United States, the defense of LIFO often rests on the assertion that it recognizes the effects of inflation and is thus similar to the replacement value theory. This defense should not, however, be taken too far. It is

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[96] Arts. 155(1), (2).

[97] Art. 155(2). GERHARD MUELLER, ACCOUNTING PRACTICES IN WEST GERMANY 10-11 (1964).

[98] Art. 155(3).

[99] Art. 155(4).

[100] Art. 155(1).

[101] EStR, Art. 36 (1963). International Bureau for Fiscal Documentation, *supra*, I-C:25.

[102] I.B.F.D., *ibid.*

[103] EStG, Art, 51(1) 2(b).

[104] Davidson and Kohlmeier, *supra*, note 75, 191-2.

true that the income statement results of both approaches may be very close. But because LIFO does not use standard costs based on current price levels, the information which it generates for management use will be different and, in Dutch eyes, inferior.[105]

FIFO may always be used to compute taxes. Replacement values are never allowed. LIFO is available to any newly established firm, but may be adopted by an existing business only in an unusual case. Other methods accepted by the tax authorities are average, actual and base stock. When the last method is used, the quantity of inventory normally needed is determined, and that quantity becomes the base stock. The base price is determined by the price of the first purchase in the first year in which the method was used.[106]

Appendix

The EEC Commission has issued, as part of the move toward corporate uniformity, a proposed set of accounting principles. More interesting than the principles is the objective of the proposals: *"Elles ont pour objectif de fournir aux associés et aux tiers des informations equivalentes et une image aussi claire que possible du patrimoine, de la situation financière et des resultats des sociétés anomymes . . ."*[107]

It is not clear why the Commission is presently concerned with uniform accounting. The sources of accounting within a country are determined by tax laws, corporation laws, accounting societies, etc. In the Netherlands, the accountants have more or less shaped their own practices. That is not true in France where the government policy of *dirigisme* must rely on economic information received from uniform reports. In Germany *dirigisme* is not as popular. But the Germans have been able to obtain some uniformity through the Share Company Law. The Dutch commercial laws impose almost no accounting requirements.

When the Community develops a uniform corporation law, when its tax laws are harmonized, when the role of *dirigisme* is determined, then will come the time for decisions as to uniform accounting. It is more than likely that when those other areas have achieved uniformity, accounting will, as a by-product, also be uniform. That is so because accounting is not an end in itself but a tool. The shaping of the broader policies will carry with it a definition of the requirements of accounting.

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[105] *See* A. Goudeket, *An Application of Replacement Value Theory,* 110 J. OF ACCOUNTANCY 37, 41 (July, 1960).

[106] ARTHUR ANDERSEN & CO., TAX AND TRADE GUIDE, THE NETHERLANDS 31 (1965).

[107] Commission Des Communautés Européenes, Droit d'établissement et services, Rapprochement des législations, Problems fiscaux, IV-2/2800/68-F, p. 1.

If the Commission wishes to work with accounting now, there is, however, something to be achieved. Very little is known about the decision models of the various groups of persons interested in corporations, *e.g.*, management, present shareholders, prospective shareholders, lending institutions, etc. Work in this area could yield results. To state simply that the objective of uniform accounting is to furnish all interested people with uniform information is to avoid the problem.

The following table giving sources of corporate funds may help to clarify the discussion. The imprecision inherent in the figures is not important for present purposes:

Sources of the Capital Funds of Enterprises[108]

	FRANCE		GERMANY		U.S.
	1960-65	1959-64	1960-65	1959-64	1959-65
Internal Financing	53%	55%	63%	60%	67%
External Financing	47%	45%	37%	40%	33%
Shares	7%	12%	4%	11%	2%
Bonds	4%	17%	2%	13%	7%
Med. and Long-Term Debt	20%		15%		4%
Short-Term Debt	13%	6%	7%	16%	15%
Others	3%	10%	9%		5%

Internal financing is more important in the United States than in either France or Germany.[109] Almost half of the external financing in America takes the form of short-term debt. American firms rely on this source more than their European counterparts. In France and Germany, medium- and long-term debt and stock issues play a more significant role. When the financial statements are prepared, can it be assumed that management, investors in shares, persons lending for extended periods and those loaning for short terms, all need and use the same information? Probably not.

Predictions of future income are, of course, important to everyone. But since future income is the chief determinant of future dividends, future

[108] OECD, Committee for Invisible Transactions, CAPITAL MARKETS STUDY, GENERAL REPORT 41 (1967).

[109] The French rate of internal financing is said to have climbed to 70% in 1964 due to a decline in investments. *See* Philip Huyck, *The French Capital Market: Institutions and Issues*, 16 AM. J. COMP. LAW 219, 221 (1968).

market prices, and future ability to repay long-term debt, it is probably of most importance to present and prospective equity holders and to those whose investment, because of its long-term nature, is similar to equity. For short-term creditors, however, predictions of future financial position and debt-paying power may be more important than predictions of future earnings. Customers and employees also may be more interested in financial position than earnings.[110]

If what has been said is true, then a single statement, or group of statements, based on a single set of accounting principles may not be sufficient to supply the necessary information to all interested persons. An interim solution to this problem is to supply all information, which means historic as well as replacement figures, thought to be relevant to the decisions of any substantial group of investors.[111] But if more than a stop-gap solution is desired, more will have to be known about the decision models of each of these investor groups.

Work in this area would have to consider the role of the accountant. At one time, in the United States, it was thought that because the accountant contracted with a firm, only the firm could attack his negligence. The people to whom the firm showed the accountant's work had a cause of action only if the accountant was guilty of fraud. Third-party beneficiary law was not thought broad enough to protect outsiders from negligence.[112] Today the law is otherwise: "The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client."[113]

The SEC's sympathies are probably in the right place, but the rule is not very satisfying. A duty to a group labelled the public, a group comprised of myriad elements each of which requires different information, is a difficult duty to discharge. That is not to say that the duty should not exist. But if more were known about who the public is and what is needs, the accountants' role would be easier to perform and, doubtless, would be better performed. It is in this area of defining the public and analyzing its investment-decision models that the Commission could make a substantial contribution.

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[110] *See* AMERICAN ACCOUNTING ASSOCIATION, A STATEMENT OF BASIC ACCOUNTING THEORY 23-24 (1966).

[111] *Ibid.*, 19, 22.

[112] Ultramares v. Touche, 255 NY 170, 174 NE 441 (1931).

[113] *In re* Touche, Niven, Bailey and Smart, 37 SEC 629, 670-671 (1957).