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TAX ACCOUNTING VS. MANAGEMENT ACCOUNTING

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The Problem

The reconciliation of the needs of "management accounting" with the strict requirements of "tax accounting" is probably the primary problem of those who have responsibility of the management of tax matters of a corporate business enterprise.

The Cause

It would appear that well-nigh every human, or at least, business relationship is governed by either common or statute law and the interpretations thereof by the courts of the land. Therefore, while management is prone to argue that accounting practice and procedure are matters of management opinion, it would seem obvious that actually they are matters of law.

In this connection I would cite the corporate, securities exchange, interstate commerce, fair trade, federal trade, sales, public utility, labor relations, wages and hours and workmen's compensation laws as a few of the many such statute. Last but not least are the taxing statutes of the federal, state and other political subdivisions.

In addition we have the common law or custom which in the absence of any legal precedent establishes legal authority for our actions.

Take for instance the status of the very existence of a corporation, which I feel is best described by the astute and lovable former Dean Grayson of the Wharton School of Accounts and Finance, University of Pennsylvania, as follows:

"A Corporation is a Creature of the Law, Conceived in Iniquity and Born to Distress . . . the Stockholder."

Statute and case law precedents and authority are notable for their absence in connection with "management accounting" principles. It is true the various state corporate statutes contain some meager provisions such as those relating to limitations of accumulated earnings available for distribution of dividends, and definitions of "capital" or "capital stock," etc. Court decisions as to the definition of assets, profit and loss, and the charges or credits making up such items and the accounting treatment thereof are extremely scanty. Only in the field of public utility accounting

*This article is not to be considered the official view of the company with whom the author is associated.

is there any large body of law which is applied uniformly by the various controlling governmental agencies.

It is true that since the inauguration of the Securities Exchange Commission a certain amount of administrative law has been created, but it is of very broad application and leaves a great deal to the professional judgment of the accountant and management.

The point I am trying to make is that most of the legal authority for resolving the problems as they arise exists largely in custom.

To have any legal authority a custom must be the general custom and accepted as such. With this in mind let us examine the much used phrase, "Generally accepted accounting principles consistently applied." We must first determine what the "accounting principles" are. Any attempt to do so has and continues to promote well-nigh endless argument and controversy among accountants and management, except in the realm of public utilities wherein they are laid down by administrative fiat having the full force and authority of law.

Passing then to the questions of who accepts them and are many of them generally accepted, we find that evidence of such acceptance appears to be lacking, in many instances, by a perusal of the pronouncements of the American Institute of Accountants and other authoritative announcements by accountants.

A large area of this disagreement is obviously due to variance in the demands of management of different types of industry such as extractive, manufacturing, trading, etc. For instance I would challenge anyone to furnish a definition of that oft used and abused accounting term of "cost," which is generally accepted and consistently applied in management accounting, excluding possibly public utility accounting in which instance a definition is implied by the Uniform System of Accounts prescribed therefor.

Probably at this point we should exclude "public utility accounting" from the term "management accounting" inasmuch as it might be considered as having progressed into the realm of accounting which is governed by statute or administrative law rather than by "professional or managerial opinion." It is true that the published reports of these enterprises are issued in the same format as that used by other corporate enterprises, *i.e.* the "management accounting" form, but the real difference exists in the fact that uniform basic accounting principles, practices and procedures have been used to develop the results in each instance in the case of the utilities, and the results are therefore comparable irrespective of the form of presentation.

Can this be said in respect of the published reports of say two manufacturing organizations producing similar products?

One of the oft expressed complaints of accountants and management

is that against the type of "regimentation" inherent in the present uniform accounting theories and practices imposed upon public utilities. Their plaint is that it curbs their professional and managerial independence. On the other hand they appear to endeavor to reduce accounting to an exact science, yet they insist on the authority of independence of professional opinion in applying varied units of measurement to express the results of business operations within the same industry.

Turning now to tax accounting we discern an entirely different situation. In this field every principle, rule, definition and procedure is a matter of legal dictation. Any deviation therefrom for tax purposes is subject to penalty or even physical punishment. No area of professional opinion or judgment exists.

Prior to the inception of the excess-profits tax with the enactment of the Revenue Acts of 1917 and 1918, the practice and procedures of accounting were for the most part haphazard and were largely the reflection of the attitude of the management. For instance practically all banking institutions wrote down, at time of purchase, all physical assets to the nominal sum of \$1, whereas many manufacturing and other businesses maintained their books of account on a current and ever changing market value.

It was the impact of the excess-profits tax which forced a change from these practices and procedures.

The revenue laws provided for certain exemptions from the excess-profits and related taxes calculated on a percentage of invested capital.

Invested capital was determined on an historical dollar cost basis, and depreciation and other deductions were calculated on that same cost and the estimated lives of the respective assets, necessitating a complete review and recording of such investment. (The above does not, of course, refer to March 1, 1913 values which were sometimes recorded on the books, but ordinarily were reflected in off-side records.)

As a result of litigation during the period from 1918 to 1953 a great and exhaustive body of "tax accounting" law was created. Practically every accounting principle and practice was judicially, where required, determined for taxing purposes.

Accountants generally resisted the application of these well thought out accounting rules to "management accounting" for the reasons heretofore set forth. They insisted and continue to insist that the books of a business enterprise be kept on the basis of "management accounting," and that the financial results of operations are more correctly determined than they would be under the legal rules of "tax accounting."

Possibly we may be "right" although the "rightness" or "wrongness" of either approach can only be determined by judicial decision. Under the

"comity of the courts" doctrine the rule appears to be that, in any controversy regarding accounting principles, practices and procedures, in the absence of any legal determination thereof for "management accounting" purposes the legal determination for "tax accounting" purposes will prevail unless the controversy can be, by logic and fact, distinguished therefrom.

Many accountants and businessmen recognized the legal benefits accruing from the recording of transactions on the books in accordance with "tax accounting" principles, practices and procedures, the chief of which was legal precedent in the event of controversy.

During this same period from 1918 to 1953 there was a constant plea on the part of some accountants that by statutory amendment "tax accounting" be brought into conformity with "management accounting."

A great measure of success in this respect was attained by the enactment of the Revenue Act of 1954.

However, before the ink was scarcely dry a tremendous turmoil arose as the result of accountants and management not desiring to record transactions under the formerly desired new rules. Witness the vast number of business enterprises who for tax purposes record "depreciation" in accordance with one of the beneficial methods provided by the Revenue Act of 1954, but continue to maintain their books of account and render their financial reports on the basis of "management accounting."

The Effect

This last named situation therefore makes necessary a conversion of the results so achieved to a result which is in accord with the principles, practices and procedures made mandatory by the taxing statutes and judicial interpretations thereof.

The primary responsibility of the chief accounting officer of a corporation or other business organization is to account to its officers, directors, stockholders, owners and, in many instances, the public, as to the financial results of operations.

On the other hand, the primary responsibility of the tax manager is to account for such results to that wraith-like, now senior partner, Government, and determine the amount of the legal share of such profits to which Government is entitled, such share being prescribed by law, unilaterally at the whim of such senior partner, and not bilaterally by agreement, as is the case in ordinary business dealings.

It is this dual reflection of results of operations which must be reconciled by the tax manager by education and persuasion.

It is to be borne in mind that the original recordation of a transaction on the books of a business enterprise could, and often has been, considered *prima facie* evidence of intent and terms, and any different treatment or

reclassification for "tax accounting" can only be defended by overcoming the presumption with factual evidence. This can be and often is a financially expensive process even though successfully defended in the end.

It is therefore necessary for the tax manager to endeavor to have the transaction recorded in such fashion as to accomplish the desired dual reporting without incurring any disability insofar as taxes are concerned. In this connection financial expediency often dictates a recordation in accord with "tax accounting" and a sacrifice of "management accounting" principles, practices and procedures.

Utopian Solution

From the standpoint of management it would appear substantial benefits would accrue if each industry were to adopt uniform accounting principles, practices and procedures similar to the uniformity presently existing in the case of utilities.

From the standpoint of the volume of legal authority and precedent presently existing in respect of "tax accounting" it would appear desirable to select those principles, practices and procedures as the basis for such uniform accounting.

Obviously, due to the existing accounting law in respect of utilities it would appear to be advisable to amend the taxing statutes to permit the utilities and similarly controlled industries to determine their tax liabilities on the basis of their uniform systems of accounts as established under the applicable controlling statutes.

The main benefits to be achieved would appear to be, as follows:

1. Establishment of common units of measurement of the financial results of operations for comparison within each industry.
2. Provide legal defenses in the event of controversy.

Addenda

If the above uniform industry accounting practices were ever adopted it is obvious that management, for control purposes, would require additional accounting data and information which would not be reflected in the resulting financial reports, but these could be compiled and reported in off-side reports. Such reports could cover any required process cost comparisons, product profit performance, return on investment, make or buy analyses, sales analyses by areas, product lines, etc.