

## BOOK REVIEWS

UNACCOUNTABLE ACCOUNTING. By Abraham J. Briloff. New York: Harper & Row, 1972. Pp. xvii, 365. \$9.50.

Nineteen seventy was a bad year for the Chrysler Corporation. Despite heroic cost-cutting efforts, Chrysler reported a net loss of \$7.6 million.<sup>1</sup> But things might have been even worse; if Chrysler had not changed its method of accounting for inventories from LIFO to FIFO its 1970 loss would have been some \$20 million greater. The change did not, of course, result in any increase in revenues for the company nor, except on paper, were its costs reduced. Chrysler's \$20 million "saving" as a result of its accounting change resulted from its being able to compute its production costs by assuming that the inventories consumed in production were its oldest (hence least expensive) rather than its most recently acquired (hence most expensive) inventories.<sup>2</sup> The existence of a state of affairs that permits a company like Chrysler to choose to report its 1970 loss as either \$7.6 million or \$27.6 million, as management thinks fit, is sufficiently disturbing to warrant a moderately detailed discussion of the accounting rules that make this sort of thing possible.

The first question suggested by Chrysler's accounting games is why Chrysler was on LIFO in the first place. Since LIFO consistently produces lower profits than FIFO, why would any management choose to use LIFO? While it is possible that some companies have chosen to use LIFO because they really believe it produces a more accurate

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1. Wall Street J., Feb. 10, 1971, at 2, col. 2.

2. To illustrate, suppose that the Leviathan Corporation has an inventory of two widgets. The first was purchased on January 1, 1970, for one dollar; the second was purchased on December 1, 1970, for two dollars. Suppose further that one widget was consumed in Leviathan's production during the year. Under FIFO (first-in, first-out), Leviathan would be regarded as having used its one-dollar widget in that production, while under LIFO (last-in, first-out), production costs would be computed by assuming that Leviathan had consumed the two-dollar widget. When prices are rising, as they generally are, LIFO will show higher costs, hence lower profits, than FIFO. Some accountants have even suggested the use of an abomination called NIFO (next-in, first-out), in which the prices paid by a company for its inventory are ignored, and profits are computed as if the company had purchased its inventory at current replacement cost.

income figure than FIFO, a more likely explanation is that LIFO is used for tax savings. Unlike most accounting methods, LIFO must be used for reporting income to shareholders and creditors if it is used for tax purposes.<sup>3</sup> Significant use of LIFO did not begin until after that method was approved for tax purposes in the late 1930's. Chrysler's change to FIFO was achieved at a cost of \$53 million in additional taxes, which it was allowed to pay at \$3 million a year for twenty years.<sup>4</sup>

A more basic question is whether LIFO or FIFO is a more satisfactory way of measuring income. Everyone agrees that FIFO comes closer to reflecting the actual flow of goods through inventory in most cases.<sup>5</sup> Consider, for example, the inventories of a meat packer. Under FIFO, the meat packer's inventory will consist of its most recent purchases, which probably conforms closely to reality. Under LIFO, the packer's inventory will be deemed to consist of its oldest purchases, say those of 1929. The thought is enough to make one a vegetarian, though of course LIFO can be used by canneries. Save for inventories of products that do not deteriorate or become obsolete,<sup>6</sup> it is safe to say that businesses do not keep their oldest stock on hand indefinitely, while selling off their most recent purchases first, though LIFO allows them to report income and pay taxes as if they did.

LIFO, then, cannot be justified as a method that conforms to the actual flow of products through a business. Its proponents justify its use on two grounds: it matches current costs with current reve-

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3. See INT. REV. CODE OF 1954, § 472(c).

4. See Wall Street J., *supra* note 1. This \$53 million figure represents only *past* tax savings that Chrysler had to pay back in order to be permitted to change to FIFO. It does not include the additional taxes that Chrysler will have to pay in every future year as a result of having to report higher income in those years. I am not aware of any litigation involving Chrysler's switch to FIFO, though it is mildly amazing if every Chrysler shareholder considers the more than \$53 million spent by Chrysler for the privilege of issuing attractive financial statements as money well spent. The \$53 million figure is that reported by the *Wall Street Journal*; Briloff reports (apparently because he is using the wrong increase in inventory values) that it is \$75 million. A. BRILOFF, UNACCOUNTABLE ACCOUNTING 37 (1972).

5. T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 248 (1971).

6. When LIFO first became generally acceptable for tax purposes, its use was restricted to industries having relatively simple inventories of items that could be easily measured in units. The development of the dollar-value method of valuing LIFO inventories made LIFO available to more complex industries such as manufacturing and retailing. See Galliher & Stewart, *LIFO: Fundamentals, Pooling, and Computations* A-44 to A-45, BNA TAX MGT. PORTFOLIO 69-2d (1969).

nues, and it tends to reduce the impact of inflation on earnings and thus to report profits that are attributable to business operations rather than to the state of the economy.<sup>7</sup> Neither of these arguments will withstand analysis. "Matching current costs with current revenues" is the sort of phrase that sounds up-to-date and scientific, but there is no reason to suppose that it produces an income figure that is inherently more desirable than any other. The object of accounting is to match revenues with whatever costs are appropriate, and if income is best reflected by matching current revenues with last year's costs an accounting system that uses this year's costs instead lessens, rather than enhances, the accuracy of reporting income. LIFO's effect on the balance sheet shows that it uses the wrong costs. As the years go by, the balance sheets of an enterprise using LIFO become more and more unrealistic, until they show an inventory valued at the prices of the distant past. Even LIFO advocates admit this; they say that while LIFO produces a "better" income statement than FIFO it gives balance sheets that are "worse." This explanation ignores the interdependence of the balance sheet and the income statement, both of which are derived from the same ultimate financial data, including inventory figures. Balance sheets do not get out of whack by some mysterious process unrelated to the income statement. If a company's balance sheet has lost touch with reality, it is safe to say that whatever caused it to get that way has been affecting the company's income statements as well.<sup>8</sup> As for the inflation argument, a complete answer is that accounting does not take inflation into account. Whether it should do so is a difficult question, but no one has ever demonstrated the desirability of reducing reported income to take ac-

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7. These are the two arguments that sound the most plausible. There are others, most of which are patently specious. It is said, for example, that LIFO tends to result in income figures that fluctuate less from year to year than would income computed under FIFO. This is all very well, but if income actually is fluctuating it should be reported that way. I suppose that an accounting convention by which income was assumed to be \$10 per year no matter what was happening in the real world would yield an income figure that did not fluctuate, though no one would say that such a method of reporting income is acceptable.

8. To make the same point in a slightly different way, one may criticize LIFO for failing to include in income the very real benefits that a business obtains when it purchases its inventory at a lower cost than its competitors. If company *A* has purchased a thousand widgets at \$10 each, while company *B* purchased similar widgets at \$20, company *A* is clearly better off than *B*. But if the widgets are, in each case, the first widgets purchased, then *A*'s bargain will never be reflected in its income statements so long as its widget inventory does not drop below \$10,000, even though the widgets purchased at a bargain are actually used in *A*'s production.

count of inflation in the case of inventory users but not for anyone else. I doubt that the Internal Revenue Service would be amused if I were to report my salary this year as half what I am actually paid on the theory that assistant professors are paid today's salaries largely because of the inflation of the last ten or fifteen years. Yet exactly this argument is accepted in the case of taxpayers who use inventories.<sup>9</sup>

The acceptance of LIFO as a method of accounting is bad enough; the optional nature of LIFO is worse. Taxpayers such as prosperous closely held corporations, which have no particular need to present rosy financial statements, may use LIFO to reduce their tax burdens, while companies like Chrysler, with shareholders and creditors to keep happy, are compelled to use FIFO even at a substantial tax cost.

Inventory accounting is not, of course, the only area where accountants have a choice of rules at their disposal. The result is that the operations of any moderately complex enterprise may be presented to the public and to creditors as good, bad, or indifferent, according to the accounting rules employed. Thus the old story about the accountant who, when asked by a client for the sum of two and two, replied, "What figure did you have in mind?"<sup>10</sup>

*Unaccountable Accounting* is a collection of horror stories about the ways in which "generally accepted accounting principles" are used, or misused, to produce whatever kind of financial statements management finds useful, often with scant regard for reality. Professor Briloff has been reporting on questionable accounting practices in a number of industries for several years; much of this book consists of reprints of articles he has written for *Barron's*. So feared is his name that the mere rumor that Briloff planned to issue a report on the accounting techniques of homebuilding companies caused the stocks of those companies to plummet.<sup>11</sup> A favorite gimmick of those who seek "profits" through imaginative accounting when they have been unable to earn them through operations is to "sell" some of their properties at an inflated price to investors seeking tax shelters, receiving in exchange for the properties notes secured only by the properties themselves.

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9. For more on the LIFO controversy, see Committee on Concepts and Standards, American Accounting Association, *A Discussion of Various Approaches to Inventory Measurement*, 39 ACCOUNTING REV. 701 (1964); McAnly, *The Case for LIFO: It Realistically States Income and Is Applicable to Any Industry*, 95 J. ACCOUNTANCY 691 (1953); Moonitz, *The Case Against LIFO as an Inventory-Pricing Formula*, 95 J. ACCOUNTANCY 682 (1953).

10. A. BRILOFF, UNACCOUNTABLE ACCOUNTING 1-2 (1972).

11. *Id.* at 223-25.

Though the "seller" in such a transaction has received virtually none of the sales price, and continues to manage the properties and to bear any real risk of loss, it has often reported the face value of the notes as income. Briloff describes in detail how the Penn Central and its subsidiary, Great Southwest Corporation, used to set up "sales" like this,<sup>12</sup> frequently in a desperate effort to come up with "profits" at the end of a quarter.<sup>13</sup> An unnamed accountant's "imaginative accounting" succeeded in adding "millions of dollars annually" to the Penn Central's income,<sup>14</sup> but the Penn Central management, still unsatisfied, sought to put its auditors to work looking for more "situations where advantageous items tending to improve profitability have been overlooked by our accountants."<sup>15</sup> This sort of thing cannot, of course, succeed indefinitely, and the Penn Central is now in bankruptcy. For his pains in exposing Great Southwest's dubious accounting practices, Briloff was charged with unethical conduct by Peat, Marwick, Mitchell & Co., the Penn Central's auditors; the Ethics Committee of the American Institute of Certified Public Accountants found the charges to be without merit.<sup>16</sup>

When Professor Briloff is at his best, as in his account of the Penn Central's hijinks, *Unaccountable Accounting* is fascinating. I suppose that everyone who knows anything about accounting is generally aware of the existence of a "flexibility" in the rules and their application that at times borders on anarchy. Still, the details, in case after case, of the willingness of auditors to certify that highly optimistic financial statements "present fairly" the financial position of their clients, and of management's eager search for accounting profits to compensate for the operating profits they were unable to earn, are revealing. Unfortunately, most of Briloff's book is not up to the standard of the Great Southwest chapter. For the most part, Briloff is content to describe the accounting practices of an industry or a company, and then to set forth the facts that show that the results obtained by those practices are misleading. When the practice in question is as patently dubious as Great Southwest's "sales," this kind of reporting is satisfactory enough; no great degree of sophistication is required to realize that a "sale" in which the "seller" not only has received no money but cannot

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12. *Id.* at 193-98.

13. *Id.* at 217-18.

14. *Id.* at 215-16.

15. *Id.* at 215.

16. *Id.* at 222.

even compel the "purchaser" to pay does not enrich the "seller" in any meaningful way. But not all of Briloff's targets involve such obvious gimmicks. For example, Briloff devotes considerable attention to the pooling of interests technique of accounting for corporate acquisitions, which enables conglomerates to inflate their income statements by combining the income of companies they acquired for stock with their own.<sup>17</sup> Briloff concedes that pooling of interests accounting is not inherently unsound, and that the Accounting Principles Board's major pronouncement on the subject is "rational and well intended."<sup>18</sup> But he is content to argue that pooling should be "discredited and disowned"<sup>19</sup> because the way in which pooling has been applied in practice has, in the case of the conglomerates, produced demonstrably misleading financial statements. Here, as throughout *Unaccountable Accounting*, Briloff's lack of interest in analyzing the reasons why his profession has gone astray in particular cases has led him to drop his subject at the very point at which it becomes most interesting. This approach reaches its zenith in Briloff's account of Lockheed's C-5A troubles. Briloff describes Lockheed's glowing financial statements and contrasts them with the unpleasant realities of the C-5A cost overruns, which ultimately led to Lockheed's being rescued by Congress. "Where were the auditors in this mess? Where should they have been?" asks Briloff. If he knows, he isn't telling; at this point the reader who wants "a more extensive analysis" is referred to another book.<sup>20</sup>

Professor Briloff has performed a useful service by examining the many questionable "accountings"<sup>21</sup> described in *Unaccountable Accounting*, and by reporting the results of his investigations in his *Baron's* articles. Whether it was worthwhile to paste the articles together to form a book is questionable. There is virtually no analysis here of the reasons why financial statements are so often misleading. Briloff assumes that the principles of accounting are not to blame; he expresses no concern, for example, for the ease with which Chrysler was able to increase its annual income by \$20 million simply by selecting a new set of rules for describing its inventories.<sup>22</sup>

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17. *Id.* at 59-87.

18. *Id.* at 64.

19. *Id.* at 65.

20. *Id.* at 161.

21. Briloff's word. He also calls lawsuits "litigations." *Id.* at 332.

22. Chrysler's switch from LIFO to FIFO is described at pages 36 to 39; Briloff's

Perhaps because Briloff's inquiries into what went wrong in particular cases are so superficial, his proposals for improving his profession are unpersuasive and even naive. He devotes an entire chapter to an argument that accounting firms should not be allowed to perform management consulting services for their clients because the performance of such services creates a conflict of interest. The trouble with this argument is that the conflict Briloff deplors is present in the economics of auditing itself. If accounting firms were to cease all management services tomorrow they would still be dependent on their clients for their income. It is hard to see how the performance of management services can have more than a marginal impact on the independence of an auditor who is paid by the very companies whose books he is examining.

Professor Briloff proceeds from his advocacy of the abolition of management consulting by accountants to an endorsement of a host of grandiose schemes for revolutionary changes in the accounting profession. He wants shareholders, labor unions, and consumers to rise up and demand sound accounting.<sup>23</sup> He wants a congressional investigation.<sup>24</sup> He wants a "trade-court" to regulate accounting rules and "discern, and strike down, any conflicts of interest."<sup>25</sup> He wants federal chartering of corporations (though how this will improve accounting is not explained).<sup>26</sup> He wants accounting rules to be established by a consortium of representatives of management, lawyers, accountants, the Federal Trade Commission, the General Accounting Office, and the Internal Revenue Service, in consultation with the Census

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only apparent concerns are that the financial statements in which the change was described are not easily understandable and that the Internal Revenue Service permitted Chrysler to spread the tax adjustment necessitated by the change over twenty years, rather than ten years as had previously been the case in such adjustments. Briloff may be right about the incomprehensibility of the financial statements, but his own presentation of the data, in a confusing table on page 37, is no improvement. As for the propriety of allowing Chrysler to spread the tax adjustment over twenty years, Briloff's only basis for arguing that the Service's conduct was improper seems to be that Chrysler was the first taxpayer allowed such a dispensation. I am not as willing as Briloff to conclude, solely because Chrysler was the first taxpayer to be permitted a twenty-year spread, that the Service has been "selling indulgences only to the rich." *Id.* at 39.

23. *Id.* at 309.

24. *Id.* at 310.

25. *Id.* at 310-13.

26. *Id.* at 313-14.

Bureau, the Department of Defense, the Financial Analysts Federation, the Department of Labor, consumer representatives, and "society in general"—in short, everybody in the country except the Securities and Exchange Commission, which is left out so that it can play Lord High Executioner to the consortium's Pooh-Bah.<sup>27</sup> He wants the members of the old Accounting Principles Board to re-constitute themselves as an "Assiduous Plumbing Board" and as an "Anti-Pollution Board," and he swears he is serious about this.<sup>28</sup> He wants a "Corporate Accountability Commission" to "judge how effectively the modern American corporation is fulfilling its economic and social responsibility."<sup>29</sup> He wants people to sue the American Institute of Certified Public Accountants.<sup>30</sup> He wants individual accountants to search their souls and "comprehend their absolute requirement for freedom and independence for the narrative and interpretation to fulfill the expectations of society for the independent attest function."<sup>31</sup> He thinks that a "'Consciousness III' generation of accountants" will take up the "glorious challenge" of implementing these extraordinary proposals.<sup>32</sup> Surely nobody will take all this seriously.

This review would be incomplete without a word of warning to prospective readers about Professor Briloff's writing style, which is a grotesque blend of the turgid and the cute. To Briloff, "revenues" are not simply "revenues," they are "revenues (the top line of the income statement, the fountainhead from which income flows)."<sup>33</sup> A good year for the stock market is a "Year of the Roaring Bull."<sup>34</sup> A conservative financial statement is a "Twiggy-statement,"<sup>35</sup> the opposite extreme is an example of "the more revealing hot-pants attitude."<sup>36</sup> In the space of a mere three paragraphs he refers to Twiggy, bikinis (twice), full bosoms, hot pants, big busts, corsets, and falsies, all while talking about financial statements and the "prurient investors" who

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27. *Id.* at 316-17.

28. *Id.* at 321-22.

29. *Id.* at 330-31.

30. *Id.* at 331-33.

31. *Id.* at 333-34.

32. *Id.* at xvi. The term "Consciousness III" is taken from C. REICH, *THE GREENING OF AMERICA* (1970).

33. A. BRILLOFF, *UNACCOUNTABLE ACCOUNTING* 169 (1972).

34. *Id.* at 147.

35. *Id.* at 39.

36. *Id.*

read them.<sup>37</sup> Somebody at Harper & Row really should have done something about this; Professor Briloff can do better, as his *Barron's* articles show.

ALAN GUNN\*

THE LIMITS OF ORGANIZATIONAL CHANGE. By Herbert Kaufman. University: University of Alabama Press, 1971. Pp. 124. \$5.75.

*I should be sorry that any opinion of mine should shake the authority of an established precedent; since it is better for the subject that even faulty precedents should not be shaken than that the law should be uncertain.*<sup>1</sup>

Change, restructuring, and reform always seem to come too slowly, meeting obstacles created by an institutional environment. *The Limits of Organizational Change* contains a study of some of the factors which inhibit change in an organization. A business organization has incentives for self-study which are quite different from those of law schools, judicial systems, bar associations, and other organizations which do not have monetary profits as a goal. Organizations which can retain independence from money-making pressures may study their own operations as a means of substantiating budget requests or as an aid to the efficient use of allotted funds. But administrators in organizations which are not profit-oriented cannot feel the pressure for self-study and innovation felt by those in an organization where success and even survival are determined largely by amounts of money saved or earned. Profit-oriented organizations have been forced to investigate patterns of behavior, both internally and in the groups of people with whom the organizations have contact.

Such study has led to a substantial body of "business literature," which is so categorized only because it has been an outgrowth of business development. Principles of the social sciences may be used to

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37. *Id.* at 2-3.

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1. *The King v. Thompson*, 100 Eng. Rep. 10, 14 (K.B. 1787) (Grose, J.).