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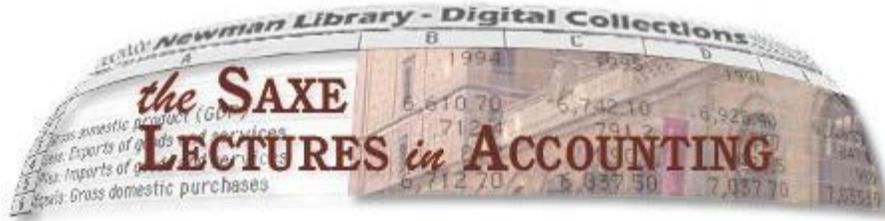
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## **MANAGERS' EMPHASIS ON THE SHORT RUN: CONTRAST WITH THE JAPANESE AND IMPLICATIONS FOR ACCOUNTING\***

by  
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**December 14, 1982**

### **I. COMPARING WITH THE JAPANESE**

When I came to this country in the early 1960s, I became fascinated by the literature on comparative economic systems. So, I earned a degree in it. At that time the area of Soviet economy was new and a number of universities had just started introducing it in the university curriculum. During that period, efforts were undertaken to understand the characteristics of the Soviet economy and its colossal management system. The results of those efforts appeared in books, research articles and congressional reports. The fundamental question was: how well is the Soviet economy doing as compared to the U.S.? The great attention given to comparing success indicators of the U.S. and Soviet economies during the sixties could only point to the fear that a communist country might be outperforming a strong capitalistic society. It was, therefore, reassuring to all believers in capitalism to discover reality: productivity in the Soviet economy was much below that in the United States. Economists point out the absence of the profit motive and individual ownership of productive assets as the reasons for the marginal productivity of the Soviet industry and collective farms. Even introducing some incentives had backfired. As it has been well documented in the Soviet economy literature, the wise Soviet factory worker should not outperform the budget even if there is incentive to do so. The reason is quite simple: the higher the performance this year, the higher the standard next year. And, by not achieving the higher standards in the next period, the worker may be penalized by more than the bonus received in the preceding period. Other dysfunctional consequences have also been documented. The Soviet economy comparison is interesting because it reflects the very fact that long term planning does not necessarily generate the incentives that will improve productivity. The literature on the subject is massive. (The book of readings by Bornstein and Fufeld has a number of outstanding articles reflecting some of these views.) It is, therefore, important to establish the premise that long range planning by itself is not a sufficient condition, either for promoting a high degree of operating efficiency, or for improving productivity.

The 1980s seem to be the decade of another self-examination of the economies of the Western world. This time the threat is from a country in which communism had failed. The 1980s is the decade of comparing the Japanese economy with the American economy. It is the decade in which many of the principles of modern management and of economic systems are being questioned. Unlike the case of the Soviet union, the Japanese did not suppress information about the performance of their economy, and they reach out to learn and exchange technological ideas with the west. As a result, success indicators of Japanese companies and of the Japanese economy are not any less known than those of companies in the United States. Success indicators of both countries can then be compared and evaluated. It is known,

for example, that the Japanese output of automobiles has exceeded the output of automobiles in the U.S.: the Japanese production of cars has increased sixty percent between 1975 and 1980 to a record of over 11 million vehicles a year, while the U.S. production was about eight million vehicles a year in 1980. Similarly, automation has been introduced at different rates in the two countries. In Japan, about 70 percent of the spot welding involved in the assembly of automobiles is performed by computer-controlled robots. That number is claimed to be 97 percent for Nissan Corp. The result of this automation is that employment in the auto industry has increased by only nine percent during the period in which the production increased by 60 percent. The significant impact on productivity was noted. On average auto production increased from 15 to 28 vehicles per worker per year during the period from 1970 to 1980. During the same period, the average number of vehicles per worker per year in the U.S. increased from nine to twelve (James Cook, "A Tiger by the Tail," *Forbes*, April 13, 1981, p. 124). In specific cases, the numbers are higher. For example, in its 1981 Annual Report, Toyo Kogyo (the producer of Mazda) reported an average production of 45.7 vehicles per worker in 1981 (p. 16). This productivity improvement is translated into a price advantage for the Japanese of at least \$1,600 per car.

In October 1982, *The Financial Times of Canada* reported different types of statistics in which the number of industrial robots were estimated to be 14,000 in Japan and only 250 in Canada. Once their programs are debugged, these robots work efficiently, do not complain, do not ask for more wages, and do not make as many mistakes as their human counterparts.

### **Comparison Between Japan and Canada Productivity Measures**

	<i>Japan</i>	<i>Canada</i>
1. Number of Industrial Robots	14,000	250
2. Research and Development as a % of GNP	2.5%	0.9%
3. Gross Fixed Capital Formation	30%	22%
4. Time needed to build a small car	31 hours	60 hours
5. Average time to replace equipment	3.5 yrs.	8 yrs.
6. 1981 average unemployment	2.2%	7.6%
7. 1981 Consumer Price Index	4.5%	12.5%
8. Growth in real GNP -- 1981	4.1%	3.1%

*Source: Financial Times of Canada, October 18, 1982, p. 14*

The information about Japanese companies is available for the purpose of critically evaluating their success indicators. Thus, many scholars and interested economists are shifting attention from examination of the quality of the information (as was the case in comparing with the Soviet Union) to an examination of the causes of that enormous success. Why have the Japanese been so successful? It would be unreasonable to suggest that their defeat in the war created the seeds of their industrial success. Several other assertions have been made. We will let sociologists and others examine the effects of the deep-rooted cultural heritage and work ethics that many talk about. In this paper, attention is directed to a different direction.

As with any new phenomenon, different authors provide different diagnoses. In a *Harvard Business Review* article (July-August, 1980), Hayes and Abernathy assert that failure to improve productivity in the U.S. is due to focusing on short-run performance and financial controls. This focus is said to be captured by several indicators, including:

1. the decline in R & D in the U.S.;
2. focusing on profit centers and profit measures to evaluate the performance of decentralized operations;
3. hiring top executives from outside the company;
4. producing products for present, not future, markets; and
5. using resources in bidding up prices of shares through mergers instead of making new investments.

In an earlier article, Banks and Wheelwright (*Harvard Business Review*, May-June, 1979) reported that corporate executives devise certain cost cutting programs, including deferral of maintenance and capital expenditures in order to meet the "constant pressure to produce ever-increasing annual profits regardless of long term strategies implications" (p. 113). They labeled this behavior as trading tomorrow's growth for today's profits. In a third article, Wheelwright further argues that "making strategic long term decisions runs against management's inability or willingness to make costly, short term decisions whose benefits, if any, do not show up in current earnings reports." (*Harvard Business Review*, July-August, 1981, p. 68).

Moving from strategic and operational analysis to the human organization, Ouchi (1981) describes the behavior of the American manager as being constrained by two dilemmas (p. 184):

1. The inability to cultivate trust and long-term human relations within the organization, and
2. Focusing on short term profits instead of encouraging long term productivity.

Illustrations are provided by cases in which the introduction of the Japanese management system to the American factory was successful. Wheelwright reported that Motorola, now a division of Mitsushita, increased productivity by 30 percent three years after being acquired. Motorola's assembly plant is located in Illinois (p. 67).

The thrust of Ouchi's comments were seconded by Morita, the founder of Sony Corporation (*New York Times Magazine*, January 4, 1981). He noted: "the trouble with a large segment of American management is attributable to two misguided attitudes: American managers are too worried about short-term profits and are too little concerned about their workers." (p. 17). In addition, "most corporate managers in the United States are now oriented to short-term profit, which tends to discourage them from making important investments in new plants, equipment and research development." (p. 42).

## **II. IMPLICATIONS FOR ACCOUNTING**

So, what does all this mean to accounting? What does it imply that corporate executives focus on short term profits? In this paper, we address the interface between some aspects of financial reporting practices and the behavior of focusing on short run profits. Possibilities can be raised in three areas:

(Item 1) The extent to which corporate executives influence the formation of accounting policies.

(Item 2) The discretionary power held by corporate managements for selecting accounting principles and methods.

(Item 3) The failure of accounting standards to incorporate the impact of technological advances for the purpose of long run analysis.

### ***1. Influencing Accounting Policies***

Consider first the FASB Statement No. 8. Corporate executives in the U.S. were very critical of that foreign currency translation standard, and mainly after it became effective. Similar reasons were reported in every popular financial journal. An interesting article was reported by the *New York Times*

on December 8, 1976. The essence of that article and others like it is contained in a *Forbes* article (October 13, 1980, p. 192) which reads as follows:

"The rule created huge earnings swings in virtually any firm that did substantial overseas business. Worse, these swings had little to do with how well the overseas subsidiaries were really doing."

In many ways, corporate executives and financial analysts complained: Predicting corporate earnings became more difficult because of the volatility introduced by the effects of the translation of financial statements of foreign subsidiaries on income. Their concern was manifested in undertaking two types of activities:

- (a) modifying their approach to managing foreign currencies and foreign operations as reported by Evans, Folks and Jilling (1978); and
- (b) pressing the FASB to change the standard.

These actions continued even after the financial press had labeled, properly so, the translations gain or loss as "paper profits." But as long as the gain or loss impacts reported income, the best available option was to change the standard. After a long wait, their wish was granted. In 1980, the FASB issued Statement No. 52 superseding Statement No. 8. The statement introduced some innovations: a concept of functional currency and sheltering the measurement of income from the gain or loss of translations. Since the new standard requires by-passing the income statement by directing the translation gain or loss to an equity account on the balance sheet, one would have thought that corporate managers got their wish. No, not quite! Many executives were rather unhappy because Statement No. 8 was being replaced at a time when the old and condemned statement was beneficial: Please note that short term profits were enhanced by "gains" from currency translations using the method of Statement No. 8. In a period when the U.S. dollar is strong overseas, applying FASB Statement No. 8 turned out to be advantageous for the more multinational companies. And, those who cursed it when the dollar was weak, loved it when the dollar was strong. In some respects, this is an implementation of one point of view of the criterion of "relevance." That is, take it when it helps short term profits, but have it changed when it does not. Consequently, not very many companies are rushing to adopt Statement No. 52 earlier than they have to. By one estimate (*Forbes*, May 24, 1982, p. 86) about one half of the Forbes 500s will wait as long as possible.

The story gets a bit nasty when FASB Statement No. 19 is remembered. Having inherited the problem from the APB, and being pressured to act by the SEC, the FASB moved slowly, through the now familiar due process, to develop a standard for oil and gas accounting. At the end of the process the successful efforts method was voted in, and the full costing method was voted out. Unfortunately, that was not for long. The oil and gas companies that followed the full costing method declared an "accounting" war. The FASB was told the method is "not relevant" to the interests of managements of those companies. The reason for the alleged lack of relevance must be noted: the successful efforts method induces volatility in reported earnings. Many of the smaller oil companies threatened to substantially reduce exploration efforts in order to avoid the swings in earnings if the standard was to go into effect. The threat was made at a time when regulators wanted to hear the opposite. The lobbying efforts intensified, the SEC gave in to the pressure, and the FASB was asked to rescind the standard. The unpleasant story of accounting for investment tax credit of the early 1960s was once again repeated. Why? Because of the impact on short-term profits.

The SEC created its own alternative, the reserve recognition accounting (RRA). According to the method, reserves in the ground were to be estimated by specialized engineers and, by some arbitrary means of transformation, a dollar number would be assigned to them. The RRA method was also resented for nothing but the same reasons for which FASB 19 was rejected; namely, inducing volatility in earnings. To this concern of the impact of RRA, Clarence Sampson, the chief accountant of the SEC,

was quoted as saying: "Businessmen get very upset when they see volatility in earnings. But from a regulator's point of view, they should show volatility when there is volatility" (*Forbes*, September 29, 1980, p. 133). As much as the RRA method was disliked, companies complied with it but asserted that the numbers "are meaningless and misleading." But the experiment did not last long; many managers and analysts saw it as irrelevant to their needs. Once again the criterion of relevance has been given a new twist.

The problem is not new. Admittedly these are the ones about which large battles were fought, but they serve to highlight the strong influence that corporate executives *exert on accounting policy in order to get away from* accounting standards that do not reflect well on their short-term profits. Thus, the focus on short-run profits is coupled with this managerial disease that is called "earnings volatility." It is not clear to me why accounting standards are fought if, as Sampson indicated, they show volatility when there is volatility. The three cases cited above (the accounting for investment tax credit, the accounting for translation gain or loss, and accounting for oil and gas), indicate some of the dysfunctional consequences for accounting policy making that result from focusing on short-term profits by corporate executives. It appears that these dysfunctional consequences are strengthened by the interaction of two accounting objectives:

1. the primary focus of financial reporting is information about earnings and its components (FASB Concepts Statement No. 1), and
2. the relevance of information to users is the primary qualitative criterion in financial reporting (FASB Concepts Statement No. 2).

Given these qualities, an accounting standard is fought if it becomes inconsistent with achieving the short-run profits to which managers aspire. The method of attack is simple: the standards that induce volatility in earnings, or that would undermine profits in the near term are considered not "relevant." Such behavior is consistent with the self-interest hypothesis advocated by others (e.g., Watts and Zimmerman, 1979), and the hypothesis that setting accounting standards is a political process (e.g., Solomons, 1976).

Managers' concern for volatility of earnings is not a new hypothesis; it underlies the research on income smoothing that was initiated by Gordon as far back as 1964. According to that hypothesis, managers see their rewards to be inversely related to the variability of reported income. Although researchers have not succeeded in directly evaluating the income smoothing phenomenon, specific cases do support it. A good summary of this research is reported by Ronen and Sadan (1981).

The discussion here would be incomplete without a mention of FASB Statement No. 2, Accounting for R & D. In essence, the standard might be accused of inducing earnings volatility if companies do not alter their R & D activities because of the change of policy to expense all R & D expenditures as incurred. The research on this subject is inconclusive. In a recent paper (1980), Horwitz and Kolodny concluded that small high technology firms were adversely affected by the R & D standard. Wolfson (1980) questioned the validity of that conclusion in view of the research method used, and in view of the findings reported by Dukes, Dyckman and Elliott (1980). Given the history with FASB Statement No. 8 and Statement No. 19, it is somewhat surprising that managements did not lobby to change Statement No. 2. There are several hypotheses that one can generate to explain this phenomenon. First, Statement No. 2 was issued in 1974, a period in which national expenditures on R & D were starting to decline. Second, being the second statement by the FASB, there was not enough time for the lobbying machinery to quite understand the operations of the new system and to develop a method of attack. Third, the conceptual framework was not formulated and the "user primacy" criterion was not engraved in official documents. Fourth, companies that were heavy in R & D continued to undertake R & D activities and found contractual arrangements that are satisfactory from the viewpoint of the effect on income. Finally, companies were given a bit of leeway as to classification of R & D into "basic" R & D or engineering development.

## 2. *Selective Choice of Accounting Policies*

One of the other problems we have in our profession is the absence of a reasonable specification of the conditions under which accounting principles and methods can be changed. Corporate managers continue to hold a strong discretionary authority over those choices. And, given their orientation for short-term profits, the discretion is often applied more selectively than can be justified by any theory of income determination. My first case is the choice of the measurement of cost of capacity utilization. Although the problems with the measurement of the cost of using fixed assets is a favorite example of Art Thomas and Bob Sterling, I do not think I will sound like them. The measurement of depreciation has always been as arbitrary as anything in accounting; in fact, Thomas and others do not call it a measurement. It is an allocation of a number. The problems of measuring the cost of using capacity is even more complicated by the flexibility of the choices allowed. Managers have the authority to determine: (a) the useful lives of assets; (b) the arbitrary method by which the assets will be consumed; (c) the salvage value of the asset, and (d) the changes in any of the above. This latter point is what concerns me here. The changes in depreciation (both the timing of making the change and the amounts) are often dictated by things other than the rate of capacity utilization. It is a viable hypothesis to assert that accounting changes, in general, and changes of depreciation, in particular, are motivated by the desire of corporate management to influence near term profits. To avoid being misunderstood, I believe that APB Opinion No. 20 came a long way in requiring disclosures of these changes. But the disclosure of actions is not enough. *Accountants have been given the social role of income determination.* Accounting policies should not abandon that responsibility by permitting accounting changes that are motivated by anything other than providing a better measurement of income or evaluation of performance.

To illustrate the dilemma, consider the recent changes made by Union Carbide, a financially healthy company which, in 1980, extended the estimated productive lives of machinery and equipment by more than two years. A short period? Yes, but the impact on net income after tax in 1980 was \$94 million. I presume that an approximately equal amount was incorporated in the 1981 net income. In addition, the company changed the method of accounting for investment tax credit *from deferral to flow through*. The impact was \$24 million dollars added to net income from continuing operations after tax, and \$217 million in cumulative effect. After making some simple calculations, it appeared to me, without these changes the reported EPS for 1980 and 1981 would have been flat. Not knowing the inside story or the motivation for making these discretionary accounting changes, I could only hypothesize that these changes were made in order to boost near term reported accounting earnings. This is particularly important in view of the statement made by the company's management: "These changes do not affect income tax payments or cash flow." (Union Carbide, 1981 Annual Report, p. 21).

I do not want to be misunderstood, Union Carbide has one of the better annual reports I have seen. I could have picked any other company that made similar accounting changes. The point being made is simple: discretionary nature of managerial choice of accounting methods; the particular company used for illustration is not of any consequence. The same question can be raised of others. In 1981, Chrysler, Burlington Industries, and McGraw-Edison switched from accelerated to straight line depreciation methods for accounting. And, it is not all too recent. In 1975, for example, American Airlines extended the useful lives of its airplanes for the purpose of income determination. According to one report (Jane Carmichael, "The Wild Blue Yonder," in *Forbes*, November 9, 1981, p. 94), "Without that little windfall, American's 1975 loss would have been \$1.11 a share, instead of the 72 cents it reported." Another case is the accounting change made by ABC in 1980. The percentage of the cost of a new show that is charged off the first time it is broadcast was changed from 80% to 76%. The effect of net income after taxes was substantial (Thomas Baker, "A Question of Judgment," *Forbes*, February 16, 1981, p. 52.)

Relevant questions need to be answered:

Do these or similar types of accounting changes *better assist investors and creditors* in predicting future cash flows as to amounts, timing, and uncertainty?

Do these types of changes assist investors and creditors in better evaluating the performance of corporate managements?

If not, why permit them?

As far as I can tell, both as a professor of accounting and as a potential user of financial statements, the objectives of financial statements are not known to be better served by any of these types of accounting changes. I will set aside for the moment my own biases against the implementation of the criterion of "relevance," but I cannot set aside my biases against managers' obsession with short run profits. Accounting ought not to be abused in order to satisfy that desire. The preoccupation with short term profits is often asserted as the reason for the refusal of many companies to switch to LIFO given that managers know the result will be a reduction in accounting earnings. The unconditional gift from Uncle Sam that would accrue as a real reduction in the tax burden is often not seen fit to justify the externalities associated with reporting lower accounting earnings. Never mind that the financial press sometimes refer to it as "paper profits" as it did with respect to the foreign currency translation gain or loss. Similarly, questions are still being asked: "Why did Chrysler change *from* LIFO in 1970 and incur an additional tax payment of over \$50 million? There can be little, if any, long term consideration for making a decision of that type.

The morale of these stories is simple. As long as corporate executives are given a wide discretion for making choices of accounting policies and principles, managers' concern for short term will be the dominant criterion for making these choices. The chosen alternatives will often be those reflecting favorably on short run profits. It is not difficult to assert that accounting policy makers have given corporate managements an easy way to manage their short-term profits.

### ***Ignoring Technological Advances***

The third possible way in which accounting plays a role in this phenomenon of focusing on the short term is the manner in which financial reporting ignores the effects of technological changes. In this respect, the current cost approach adopted by the FASB in Statement No. 33 is inadequate. To explain the problem let us consider the sources of difference between income determination under current cost and historical cost. Under the current cost system of Statement No. 33, depreciation is the major source of the difference between current cost net income and historical cost net income. To illustrate, consider the following cases of three companies:

<b>(CC-HC) in 1981 Fiscal Year</b>	<b>Kroger Co.</b>	<b>LTV Corp.</b>	<b>Union Carbide</b>
Difference in C.G.C.	\$ 6 mm	\$14.8 mm	\$ 69 mm
Difference in Depreciation	\$47 mm	\$90 mm	\$200 mm

These examples are provided to illustrate a point: When companies use historical cost to estimate the cost of using capacity, depreciation is likely to be understated. A corresponding overstatement of accounting income results. Thus, executives who are interested in short-term profits should always prefer to use lower charges for the cost of capacity in the short run. Thus, the incentive for renovating capacity and charging the higher cost of using capacity against income becomes more constrained. The resulting rate at which equipment is replaced is slow. According to the *Financial Times of Canada*, the average time to replace equipment in Japan is about 3.5 years, compared with about 8 years in Canada. And, as stated elsewhere, the average age of GM's assembly plants as of 1980 was 39 years (Sloan and Miles, "GM's Chance of a Lifetime?" *Forbes*, September 1, 1980, p. 110).

Although we cannot claim that charging depreciation at historical cost was the reason for delaying replacement, the use of historical cost as a basis for measuring the cost of capacity utilization has indeed sheltered that information from users. It is even *more dangerous when historical cost depreciation*

*becomes a guideline for long term policy.* Consider, for example, the policy that DeLorean instituted while heading up the Chevrolet division of GM: "Capital expenditures should not exceed 90 percent of depreciation." (Wright, 1979, p. 120). The reason provided was straightforward: "Cutting capital budgets would force managers to use their facilities more efficiently. The figure of 90 percent was an arbitrary figure selected as a target to bring discipline to our expenditures." (p. 12).

At the heart of the matter, however, is the absence of reflecting technological changes and, hence, obsolescence in the measurement of income. Statement No. 33 (1979) did not provide an adequate response to this need. For one thing, the FASB has opted for using current cost instead of current replacement cost. As defined by the FASB,

The current cost of property, plant and equipment is the current cost of providing the same service potential as embodied by the asset owned (Statement No, 33, p. 19).

(Current replacement cost is) the amount that would have to be paid to acquire currently the best asset available to undertake the function of the asset owned. This concept of replacement cost should be distinguished from the cost of replacing the service potential of the asset owned, called "current cost." (Statement No. 33, p. 48).

Given this distinction between current cost and current replacement cost, the information required by FASB Statement No. 33 does not include enough disclosure about management's performance in face of technological advances. The user does not have a way of assessing the wisdom of management's decision to keep or abandon old technology. I realize that Revsine (1979) argues that under certain assumptions current cost (defined as deprival value) and current replacement cost would have the same information content. The problem with Revsine's analysis is the set of restrictive assumptions imposed. In particular, he assumed that technological advances are limited to those resulting in variable (or operating) cost savings, old and new assets are perfectly divisible and no barriers to entry. Capital savings and quality improvements are ignored.

Finally, we have seen how the Japanese succeeded in uniquely substituting robots for human labor. Without including effects of technological advances, it would not be feasible for users to judge the quality of management's performance vis-a-vis those issues. The investor did not know for a long time that GM did not abandon old plants when it should; the information was not there.

An additional reason for confounding the problem is the *extension* of the same depreciation methods, productive lives and salvage values from historical cost to current cost. Those extensions succeed only in carrying the ambiguity associated with depreciation charges over to the measurement of the current cost of using capacity. But that is not all. The possible effects of technological advances on shortening the productive lives of existing assets are ignored.

Finally, operating expenses are not required to be adjusted for current cost. If in fact the productive assets are subject to a high degree of obsolescence, then the newer technology will not only result in a different current cost of replacement, but will also affect the operating efficiency of the would be replacement (Lemke, 1976). If you were to use the replacement cost of your car in valuing it, you should also adjust operating expenses for the added fuel efficiency and durability. Statement No. 33 did not require making these adjustments.

These three reasons are hypothesized to be some of the causes contributing to the perceived lack of usefulness of the current cost information required by FASB Statement No. 33. In this regard, I find myself agreeing with the point made by Walters in his dissent to Statement No. 33. He says:

The current cost information introduced in this Statement has significant limitations. It is neither a comprehensive current cost nor a value system. (Statement No. 33, 1979, p. 28).

### **III. BACK TO THE JAPANESE**

Do the Japanese financial reporting standards permit focusing on long-term any more than the U.S. standards?

From my readings and my evaluation of a few (translated) annual reports of Japanese companies, it is not clear to me that the Japanese accounting directs attention to the long run any more than other accounting systems. The profile of financial controls and planning provided by Pascale and Athos (1981) for the Matsushita Corporation indicates a heavy emphasis on the six months, not the two or five-year plans. Similarly, monthly reports of divisional performance and tedious monthly analysis of variances from the six months budget are highlighted. Furthermore, Matsushita is said to be "bottom line" oriented. Although the Japanese use that information internally and there are no public quarterly reports to the stock market, it is difficult to claim that Japanese forego short run measures and evaluation of performance. This is where one would start to question the diagnosis made by Hayes, Abernathy and Wheelwright. Focusing on financial controls is not unique to U.S. companies; the problem may be in the ways in which the success indicators provided by these controls are used. It is reported (*Forbes*, September 1, 1981, pp. 110-111), for example, that GM's management did not abandon old plants for new ones because of insisting on a five year payback period. The fact that GM rejected a seven-year payback period (lower ROI) does not render the technique problematic.

Although I believe we can learn some lessons from the Japanese, the present preoccupation with comparing their success with that of the U.S. companies is only a fad, not any different from the earlier comparisons with the Soviet economy to which I referred earlier.

In my view, much of the diagnosis of the causes for the success of the Japanese will provide only *partial* answers. The success of Japanese companies is due to multiplicity of factors and it would be naive to attribute that success to focusing on long run and ignoring short-term profits and various measures of financial controls.

To appreciate this point, it would be sufficient to consider the factors related to the system of industrial organizations. *Their industrial organization structure does not permit the management to emphasize the short run at the expense of the long run.* I would like to view with you some of the elements of that structure as I see them:

(A) The following statement is printed in an attachment to the 1981 *Annual Report* of the Mitsubishi Trust and Banking Corporation:

As of March 31, 1981, Mitsubishi Trust employed 5,921 persons in its operations. Of these employees, 3,161 were men and 2,760 were women... The Bank assumes that male employees, in particular, will spend their entire career with Mitsubishi Trust after graduating from university or high school. In recognition of this strong personal commitment, the Bank's philosophy emphasizes career-long, on-the-job training.... Periodic job rotation is regarded as a key element in pursuing a career with the Bank. (p. 23).

By contrast, American companies *do* hire top executives from *outside* as well as from *inside*. Job turnover in the U.S. is significantly higher and executives do not normally expect to stay with the organizations in which they started their careers. Changing jobs and improving individual's careers depends on his or her performance. Improving the income reported by an operating unit during his or her tenure in office is a key component of that performance. Thus, many executives would have to generate *loyalty to their own careers*, not to their companies. The long term success of their companies may not enter in their equation of achieving good performance. They can always use the improved short run profit in their current operation to move to another company. The setting is different.

(B) Japanese banks have a great deal of control over industrial companies. By examining the annual reports of two banks (Mitsubishi Trust and The Tokai Bank), I became more convinced of the usefulness of their power. For one thing, the Mitsubishi Trust and Bank, for example, is one of 28

Mitsubishi companies, called the Group. It is also affiliated with other companies outside the group. The Mitsubishi Group produces steel, autos, cement, electronics and all kinds of things. "The Group does not exist as a formal organization, but is a loosely-knit, informal relationship between companies based on mutual cooperation." (The supplement to *1981 Annual Report*, p. 6). "The shareholders of Mitsubishi Trust include the larger companies affiliated with the Group, as well as many companies affiliated with other groups.... Since no shareholder has as much as 7 percent of the Bank's stock, no one shareholder or group exerts significant influence on the management of Mitsubishi Trust." (p. 7). However, the report claims that the shares are freely traded on the Tokyo Stock Exchange. Given this loosely tied organization, many of the shareholders of each company in the group are not individuals who would speculate in trading Mitsubishi shares. Furthermore, no one company in the Group has incentive to play the stock market game by managing its earnings for those small investors since much of the shares are owned by other members of the Group. Finally, Mitsubishi Trust does not only perform banking services, but also *invests in corporate stocks and bonds*, performs services of underwriting and investment banking, and provides a significant source of funding for the operations of other companies. To illustrate the extent to which banks do have interest in the industrial companies they finance, consider the following ratios for Toyo Kogyo and NEC: The current ratio is close to one. The ratio of total liabilities to owners equity is between 4.0 and 5.0. The ratio of current liabilities to owners equity is over three. It looks like all current assets are financed by short-term borrowing. The financial statements of the Mitsubishi Trust and Bank refer to financing "long term working capital" among many other long term projects.

These ratios clearly show that bank loans and short term credit are major sources of funding of those two companies. They are highly levered but they will not go bankrupt because banks and other companies of the Group will see to it that every company in the Group manages for long term. As Peter Drucker reports, if a bank calls back one yen, it is a signal: the management must resign, or the company must merge with another company.

(C) The power of the banks in managing the affairs of their clients is more than we know. Please carefully evaluate the following quote from the *1981 Annual Report* of the Nippon Electric Company:

Certain of the loan agreements provide, among other things, that the company submits to the lenders (upon their request) for approval, its proposed appropriation of income (including dividends) before such appropriation can be submitted to the shareholders *for approval*. (p. 42)

This is an extremely powerful control tool: *control by veto*; control by authorization of plans even before ever being considered by the stockholders.

(D) By comparison to Western managers (according to a speech delivered at The University of Alberta in November, 1982 by R. Ballon, an authority on Japanese management), the Japanese take longer time to make decisions, but do take much shorter time to execute them. This view can be gleaned from the *Annual Report of Toyo Kogyo* (the producer of Mazda):

Three critical areas which Toyo Kogyo must address. First, we must have the ability to read and foresee the exact needs of consumers ahead of time. Second, we must be ready to translate in the shortest possible time such research into technically sophisticated products. Finally, these products must be produced with high quality at the lowest possible cost. (p. 3)

### ***What are the Implications?***

The agency theory literature provides us with one of the reasons that corporate managers in the West focus on the short-run; namely, basing executives' bonuses on accounting income. Some evidence is beginning to accumulate in that direction. According to the statistics compiled by the *Conference Board* more companies are adding bonus plans to their list of compensations. And, some annual reports such

as that of Exxon, publish a brief on the bonus plan including the cash-bonus that is based on income. It would be a mistake, however, to claim that the Japanese don't do that. The comparative data published by GM in 1981 indicate that \$2.60, or about 20 percent, of the hourly wages of auto workers in Japan consist of some type of profit sharing. For GM, the hourly wage is about 60 percent higher than Japan and none of it is directly based on profits. It is even more interesting to note the practice of Mitsubishi Trust and Bank Corporation. An item at the bottom of the income statement in the *1981 Annual Report* reads: "Bonus to Directors and Auditors." The bonus is about 0.6 percent of net income. What all this means is that basing incentives on profits is not necessarily a bad idea. The real problem is the type of motivation those bonuses generate. The motivation is likely to be different for executives who are locked in their positions, as compared to others who can change affiliation on a moment's notice.

Two other variables operate on affecting the type of motivation: the power of banks and the role of equity markets. Banks in the U.S. are heavily constrained by all sorts of regulation, while banks in Japan have a strong hand in controlling their corporate clients, investing in their stocks and bonds and essentially have facilitated financing industrialization in an effective manner. Similarly, participants in equity markets are composed differently in Japan; the majority of shareholders are banks, other corporations and financial institutions. Rumors and short-run performance tend to be much less influential on the trading of those shareholders. Western capital markets, on the other hand, thrive on all sorts of information, including the variance in profits from quarter to quarter, a practice that does not exist in Japan.

Given these organizational considerations, the focus on short-term profits will continue with us in the West. Accountants have been entrusted by society with the important function of income determination. As accountants, we must not engage in activities which facilitate the dysfunctional use of accounting to serve that end. In my opinion, though of recent origin, three issues ought to be alarming: (1) adopting "relevance" as the primary criterion for financial reporting; (2) relegating the measurement of performance to a lower level in the hierarchy of objectives, and (3) the absence of a theory to determine what is relevant (a point that was also made by Solomons (1981)). These issues are likely to entice the managers to seek changes in accounting policies only to serve their objective of reporting "good" short term profits. This problem gives "relevance" a varying interpretation that leads managers to pressure accounting policy makers to alter accounting policies and principles in a manner that is not necessarily consistent with the responsibility entrusted to them by society-income determination. The pressures to which the FASB was subjected to change Statement No. 8 and to rescind Statement No. 19 is illustrative of the problem. Accounting standards that affect reported income adversely in magnitude or volatility are fought. The history of accounting for investment tax credit with the APB is another example.

Furthermore, permitting managers a wide latitude in selecting accounting principles and methods and in altering them at will provides another vehicle. Changes in the method of depreciation and in the estimated productive lives of fixed assets are common examples nowadays. Companies change accounting principles that would "help" short-term profits. There is no good reason why income determination was suddenly made better with these changes in accounting principles and methods.

Finally, the failure of financial reporting to reveal the impact of technological changes on corporate wealth and income shelters vital information from users. With current reporting practices, it is impossible to evaluate the quality of managerial decisions to abandon or keep old technology.

These problems are vitally important in accounting and need to be studied. In particular, I propose that:

1. Policy makers in accounting must reconsider the criterion of "relevance" in view of their role in society which is "income-measurement and determination;"
2. Corporate executives may not be allowed to pressure accounting policy makers to change policies only to help short term profits;
3. The wide latitude given to corporate executives in selecting and changing accounting

- principles and methods must be reconsidered; and
4. Current cost reporting (Statement No. 33) is an inadequate response to the need to reflect technological changes and impact of technology on the financial health of the company. The Statement needs to be completely overhauled to achieve that objective.

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