An Analysis of the Balance Sheet in View of Recent Emphasis on Income Determination.

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AN ANALYSIS OF THE BALANCE SHEET
IN VIEW OF RECENT EMPHASIS ON INCOME DETERMINATION

A Dissertation

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Doctor of Philosophy

in

The Department of Accounting

by

J. Herman Brasseaux
B. S., Southwestern Louisiana Institute, 1950
M.B.A., Louisiana State University, 1951
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ACKNOWLEDGEMENT

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ABSTRACT

The recent emphasis on income determination has resulted from efforts to supply significant data primarily to corporate shareholders. As a consequence of this concentration on one area of financial reporting, the effectiveness of the balance sheet has been impaired and it has become incompatible with the income statement. Many obsolete standards of asset and liability contents and valuation continue to influence the balance sheet. These factors frequently conflict with the objective of a proper matching of costs and revenue for determining income. This lack of consistency between the two statements has reduced the general usefulness of financial reporting.

The purpose of this study is to meet the problems posed above by developing standards of asset and liability determination and presentation which are more compatible with improved procedures of income determination. Existing literature, pronouncements, and annual reports have been examined as a basis for the following observations and conclusions.

As a basic step in restoring harmony between the two statements, the balance sheet should be oriented toward the primary goal of reporting to investors. Balance sheet contents, valuation, and presentation should then be evaluated through a broader implementation of the matching concept. Assets should be viewed as monetary and non-monetary resources which have been committed to, and which will contribute to, the production of income. Liabilities should be considered as the previous inflow of resources accompanied by a claim requiring satisfaction in the future. The owners' equity category represents both the funds directly invested by the owners
Inventory cost determination should be rationalized for greater utility in income computation and evaluation through a broadening of the composition of these costs. The last-in, first-out method of measuring cost flow introduces inconsistencies between the balance sheet and income statement and should not be used for financial reporting. If the elimination of price level changes is desired, it would be better achieved through a broader methodology than LIFO. The traditional term and concept of "cost or market, whichever is lower" should be discarded in favor of reporting inventories on the basis of the lower of cost or residual useful cost. Reporting on insurance taken on the lives of executives appears inconsistent with the matching concept and should be improved. Widespread adoption of accelerated depreciation methods for tax advantages should not be carried into the financial reports unless they are realistic measures of the flow of asset usefulness. Accounting for intangibles, research outlays, and distribution costs must be critically examined and they should appear on the balance sheet in amounts equivalent to their future income producing ability. The recording of prepayments and estimated liabilities, resulting from inter-period allocation of income taxes, does not conform to the established asset and liability standards and is not recommended. Liabilities, especially long-term debts, should be shown at their discounted value. This treatment is necessary to allocate more effectively the cost of the borrowing.

Continued study of balance sheet presentation should be made for the purpose of improving analysis and evaluation of financial data. Proper orientation of the balance sheet may require revision of the
arrangement which emphasizes the showing of debt-paying ability. Persis-
tent attention must also be given to the problems of price level
changes. For the present however, the basic cost records should be
maintained. Additional useful information may be supplied through sup-
plemenary reports which contain all-inclusive adjustments for price
level changes, and which are clearly related to the primary reports.

If the balance sheet is brought into conformity with the over-
all objectives of income determination, it will regain its position as
a vital component of financial reporting.
CHAPTER I

INTRODUCTION

Statement of Problem

A survey of current accounting literature reveals one striking fact: emphasis on the income statement and income determination is predominant. Over the past two or three decades this phenomenon has been evident in journals, textbooks, and research publications. All efforts seem to be aimed at re-defining and sharpening the concepts of income and income determination. This emphasis has been perhaps a natural outcome of the increasing interest in financial information exhibited by investors and prospective investors. A characterizing feature of the past few years has been the widespread ownership of corporate securities by individuals far removed from the everyday operations of the firms concerned. This development has caused the accounting profession to feel more keenly its responsibility in furnishing absentee owners effective means of control and reliable information about their investment.

The emphasis in one area of financial data has produced a marked lack of balance and consistency between the two basic financial reports. Improvements in the area of asset and liability determination have lagged and have not kept up with developments in income determination. Particular areas of the balance sheet are prepared to meet the needs of specific users or uses. Short-term credit analysis, for example, has strongly influenced, and still does, valuation and contents in the current asset section. Traditional conservatism and high income tax rates have
influenced the balance sheet contents in the area of outlays resulting in nonphysical commodities, such as organization costs, research and development costs, and distribution costs. Attempts to show "current" inventory costs in the income statement (LIFO inventory method) have left the inventory figure on the balance sheet out of step with other items on the financial statements. In some instances the procedures used in the balance sheet run counter to the primary objective of the income statement. As a result the balance sheet has largely evolved into an aggregation of balances determined under various assumptions and with various objectives in mind. The statement has thus become inconsistent within itself and out of harmony with the income statement. Consequently, the balance sheet has lost some of its importance in analysis and is frequently considered to be of limited over-all usefulness.

The lack of consistency in the two basic reports has also hindered the utility of financial reporting in general. Obsolete practices and standards maintained in the area of balance sheet contents and valuation have influenced and handicapped income computation. As an example, conservatism on the balance sheet produces an understatement of income in one year followed by a series of periods when the income is overstated.

1"The financial services regularly calculate the book value of common stock from the published balance sheets. Presumably it is a figure of some importance. Yet it would be difficult to find any field in investment practice where a significant degree of attention is paid to the asset value of a common-stock issue — with two important generic exceptions, (public utility and financial companies) . . . Investors and speculators have found that the asset value is typically no guide at all to earning-power value or average market price. Hence they have gradually come to ignore the asset-value factor altogether." Benjamin Graham and David L. Dodd, Security Analysis, 3rd. Ed., (New York: McGraw-Hill Book Company, Inc., 1951), p. 191.
Whenever the reports are prepared with divergent objectives in view, evaluation and analysis are greatly limited. Such a vital analysis tool as the rate of return on invested assets loses much of its usefulness because of inconsistencies between income and the "base", that is, the balance sheet. Various turnovers, such as the merchandise turnover, are of doubtful validity when the inventory figures used in the computation are only remotely related to the cost of goods sold.

The problem which suggests itself is whether or not accounting can fulfill its obligation to over-all utility in financial reporting by the continued emphasis of one area of reporting. A related problem which arises centers about what can be done to update the balance sheet in order to make it a more useful member of the financial reporting group.

**Purpose of Study**

The purpose of this study is to analyze carefully the structure of the balance sheet and its role in financial reporting in view of the recent emphasis in the area of income determination. An attempt is made to establish the need of correlating more closely the developments in the area of income determination with that of improvement in the balance sheet. The inherent relationship between the two statements is stressed in order to show the need for consistency in the standards of contents and valuation of the statements. Examinations in the areas of asset and liability contents and valuation, and form of presentation are made to demonstrate that over-all utility of financial reports will be enhanced by making the balance sheet more consistent with the primary goal of financial reporting — furnishing data to investors.
Scope and Limitations

This study consists of a critical analysis of the existing literature in the field, including periodicals, books, and pronouncements of the American Institute of Certified Public Accountants, American Accounting Association, and the National Association of Accountants. Published financial reports have been examined whenever they have been considered pertinent. This examination of the literature and reports is used as a basis for observations and conclusions which are deemed appropriate to further the goal of general utility of accounting data in financial reporting.

This study is limited to an analysis of the problems of financial accounting. This term is used to signify the reporting of data to outside groups, such as owners, creditors, employees, government, and others, at regular intervals; as distinguished from internal reporting aimed primarily at various levels of management. It is assumed throughout this study that the problems in the area of large-scale, widely-owned, incorporated enterprises are of primary concern.

Definitions of terms are introduced in the body of the study as they are considered appropriate. Note should be made of the fact that

2The American Institute of Certified Public Accountants changed its name from American Institute of Accountants in June, 1957. The title American Institute of Accountants, whenever used in the study or in footnote and bibliographical citations refers to the organization now known as the American Institute of Certified Public Accountants.

3The National Association of Accountants changed its name from National Association of Cost Accountants in July, 1957. The title National Association of Cost Accountants, whenever used in the study or in footnote and bibliographical citations refers to the organization now known as the National Association of Accountants.
the terms "assets" and "resources" are used extensively and interchangeably, and are considered generally synonymous.

Organization of Study

The second chapter includes an historical review of the development of the balance sheet. This is primarily aimed at tracing structural changes which have occurred in the statement over the years.

The third chapter shows the various and expanding uses made of the balance sheet in financial analysis. This chapter reveals the influence which various groups have had on the structure of the balance sheet.

Chapter IV attempts to highlight the influence of the increasing emphasis on income determination. The need for an improved balance sheet in the light of this emphasis is presented in this chapter.

A theory of the balance sheet in the form of standards or objectives of asset and liability determination is presented in Chapter V. These objectives are introduced in an effort to make the balance sheet more congruous with the primary purpose of financial reporting as well as more closely related to the income statement. An analysis of the generally recognized concepts underlying financial statements is made in this chapter, with emphasis to show the consistency, or lack of it, of the concepts with the proposed standards.

Chapters VI and VII include an analysis of balance sheet contents, valuation, and form in view of the above standards. The specific areas selected are considered to be those in which there exists a current need for improvement. Solutions and recommendations are advanced which are designed to make the balance sheet conform more closely with the objectives presented in Chapter V.
Some of the problems of price level changes are treated in Chapter VIII. No attempt is made to exhaust this area; however, recommendations are advanced in line with those adopted by the Committee on Concepts and Standards of the American Accounting Association.¹

A summary of, and the conclusions drawn from, this study are presented in the final chapter. Pertinent general observations which suggest themselves are also included.

CHAPTER II

THE EVOLUTION OF THE BALANCE SHEET

Part I: To 1900

The first and most celebrated printed work expounding a complete double-entry system of bookkeeping is the well known Summa de Arithmetica, Geometria, Proportioni et Proportionalita by Luca Pacioli written in 1494. The earliest record, however, of what later developed into double-entry bookkeeping is found in the account book kept by a Florentine banking company in the year 1211. All evidence indicates that Pacioli's Summa was a well presented treatise on the then-known principles of double-entry. Professor de Roover states that, "double-entry did not grow out of any pre-established theory but was developed step by step by a process of trial and error."\(^2\)

The famous treatise by Pacioli is strikingly similar to procedures found in present-day text books. He instructed his readers to employ three books viz., memorial, journal and ledger. The memorial consisted of a general book of primary entry where all transactions were to be recorded chronologically and in detail. Entries were made in the journal from the memorial. This additional book of primary entry was essential due to various coinage systems in use and the lack of original.

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\(^2\) As quoted in Ibid., p. 115.
documents. The journal was later posted to the ledger. The treatise reveals that the double-entry system based upon balancing debits and credits was thoroughly understood and was in use prior to this publication. The ledger contained a profit and loss account, which though not as comprehensive as the present-day account did summarize various ventures and provided for the eventual transfer of this summary to capital. Pacioli recommended that the ledger be balanced every year, however, the practice was not widespread. It was assumed that a new book (ledger) would be opened each time the old ledger was balanced or closed. The author suggested, in order to avoid errors and "to make everything more clear" that a comparison be made of the debits and credits (trial balance) before the accounts were transferred to the new ledger. "You shall summarize on a sheet of paper all the debit items of Ledger and place them on the left-hand side, and summarize all the credit items and place them on the right ..."  

The double entry system, called the method of Venice, spread from Italy to all parts of Europe. It did not, however, experience the development and advance made in other fields of endeavor. Peragallo says, 

...not until the nineteenth century, with the full impetus of the industrial revolution and a world trade freed at last from all feudal shackles and barriers, did double entry once more forge ahead and develop into what we know as modern accountancy.  


4Ibid.  

It appears that Pacioli's method of making a comparison of debits and credits in the old ledger during the process of balancing and opening a new ledger was later altered by incorporating this feature in the ledger itself. A "Balance Account" was opened to which was transferred all of the accounts in the old ledger in the process of closing. That is, all accounts with debit balances were credited and the Balance Account was debited and all accounts with credit balances were debited and the Balance Account credited. The new ledger was then opened from the information in the Balance Account.

According to Littleton, while there is no indication that the early balance accounts were used as a separate statement, "slowly they gave rise to statements which were separated from the accounts." The development of financial statements during the Middle Ages is somewhat difficult to follow. Various statements appear to have been prepared for tax purposes and in settlement of partnership affairs. Professor de Reover states, "... the law (1427 tax) required each taxpayer to file a return listing all his property and to submit a copy of the latest balance sheet of any business firms in which he held a share." Statements presented during this early period were largely a listing or inventory of resources and liabilities. Littleton points out, however, that once statements were separated from the accounts attempts were made to arrange figures for a better presentation of facts.


7 Ibid., p. 132.

8 As quoted in Littleton and Yaney, op. cit., p. 153.
and improvements in classification.  

The earliest approach to modern arrangement as shown by Littleton appeared in *Introduction to Merchandise*, 1788, by Hamilton.  

Early British and American literature did not devote much emphasis to statement preparation and presentation. It was generally assumed that those primarily concerned, the owners, had access to the journal and ledger and, hence, separated statements were not in great demand. Soule's pioneering work did contain definite instructions, however, on the preparation of financial reports. He considered the balance sheet of "particular service when its proprietor or some of the partners reside in other cities or places than where the business is located, and they are always more convenient for reference and preservation than the books of the firm." The balance sheet illustrated by Soule included not only the resources, liabilities, and capital but also the various items of gain and loss and hence, it was the only statement prepared.

By the end of the 19th century the form, especially of the balance sheet, had been basically established and no drastic changes have been made in this area. Classification and sub-groupings were crude and unsettled and these have experienced continuous developments. The problem of the content of the statements was by this time, according to Littleton,

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9 Littleton, *Accounting Evolution to 1900*, p. 140.

10 Ibid., p. 143.

"... rather well formulated; the developments to follow were generally in the direction of refinements and expansion of detail."¹²

The question of valuation does not appear to be very pressing in this early period. Many instances are found where an "inventory" of the property was made prior to opening a set of accounts, but little or no attention was paid to the valuation of various items. Littleton includes several instances where reference is made to the problem of valuation.¹³ It appears however, that there was a lack of consistency in the methods of valuation followed.

An examination of the financial statements of General Electric Co. from its published report from 1894 to 1900 indicates what was probably one of the "better" forms of statement presentation at that time. The statement shown below, Exhibit I, is presented as an indication of the type of balance sheets published before the present century.

Patents and franchises appear as the first item on the statement apparently because of its size. The subtraction of a mortgage from the corresponding asset appears unorthodox by current standards. The inclusion of an item of Profit and Loss on the asset side of the balance sheet seems at once to be peculiar, however, this was the method of exhibiting a deficit in use at that time. The inclusion of a deficit as an asset has since disappeared from practice. The arrangement of the items follows a fixed-to-current pattern which was in common practice at that time.

¹²Littleton, Accounting Evolution to 1900, p. 149.

¹³Ibid., pp. 151-152.
### Exhibit I

General Electric Company  
Consolidated Balance Sheet, January 31, 1895

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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<td><strong>Assets</strong></td>
<td><strong>Liabilities</strong></td>
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<td><strong>Patents and Franchises</strong></td>
<td><strong>Capital Stock</strong></td>
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<td>$8,159,264.02</td>
<td>Common $30,460,000.00</td>
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<td><strong>Manufacturing Plants</strong></td>
<td>Preferred $4,252,000.00</td>
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<td>3,900,000.00</td>
<td><strong>Five Per Cent. Gold</strong></td>
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<td><strong>Real Estate:</strong></td>
<td>Coupon Debentures $8,750,000.00</td>
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<td>Edison Building, New York $412,584.63</td>
<td><strong>Accrued Interest</strong></td>
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<td>Less mortgage thereon $212,584.63</td>
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<td>Other real estate</td>
<td><strong>Accounts Payable</strong></td>
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<td>$211,198.79</td>
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<td><strong>Profit and Loss</strong></td>
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<td>$14,794,716.97</td>
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<td>At sales Office $313,651.39</td>
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<td>Sundry Debits</td>
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<td>27,989.99</td>
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<tr>
<td><strong>Profit and Loss</strong></td>
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<tr>
<td>$14,794,716.97</td>
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<td><strong>SOURCE:</strong> Published Annual Report</td>
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<tr>
<td>$313,956,258.01</td>
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Part II

Development from 1900 to 1930

Early in the twentieth century the development of modern accounting theory gained great impetus by the publication of Sprague's work, *The Philosophy of Accounts.* It contained the most advanced thinking at that time and served as a basis for elaboration and continued improvement by other writers.

Sprague gave great significance to the balance sheet and labeled it as "the groundwork of all accountancy." While this view was prevalent among writers and in practice, there was some difference of opinion. According to Sprague the balance sheet was a summing-up of the elements of wealth and comprised the following:

1. The values of assets, consisting of property and claims, to which the person, or collection of persons, has title.
2. The values of claims existing against the assets and which must be satisfied from them.
3. The value of the residue after subtracting (2) from (1) and respective proprietary interests in that value.

No elaboration is made by Sprague of the precise meaning of "value," however, it seems reasonable that some approximation of current value was intended. This view naturally led to the "net worth" concept.

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15Some early published reports of firms during the early decades of this century contained no separate exhibit of the income statement.

16Some writers, for example Hatfield in his *Accounting,* (New York: D. Appleton-Century Company, Inc., 1927), took exception to Sprague.

of proprietorship or what Sprague labeled: "Proprietor (what he is worth free and clear)" on the balance sheet. This approach was considered feasible and common when the majority of business firms consisted of small, closely owned units; however, more complex, widely owned enterprises forced a changed conception of balance sheet values. Sprague's illustrated balance sheet did exhibit modern tendencies in asset classification, that is, liquidity was the basis used, and the liabilities were separately set forth prior to the owner's interest. 18

The balance sheet practices of the early 1900's were characterized by the variety of different procedures then in vogue. There was no widespread distribution of financial statements to owners and the requirements of reports by credit grantors exerted a considerable influence upon statement presentation and disclosures. Many firms in this era took considerable pride in creation of "secret reserves" which were generally condoned and even considered desirable. This was due largely to the fact that bankers welcomed understatement of assets and the relatively few owners considered it a "virtue" to show highly conservative balance sheets.

The balance sheet of General Electric of 1909 presented below in Exhibit II illustrates some of the then prevailing tendencies in statement presentation. A remarkable feature of this statement is that Patents, Franchises and Goodwill, which only 14 years earlier (Exhibit I) had been over $8,000,000 was now down to $1. This was accomplished by a series of arbitrary write-offs of this asset. The arrangement of assets experienced considerable change from 1895 to 1909 and the order,

18 Ibid., p. 34.
### Exhibit II

**General Electric Company**  
**Consolidated Balance Sheet, December 31, 1909**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Patents, Franchises and Goodwill</strong></td>
<td>$1.00</td>
<td></td>
</tr>
<tr>
<td><strong>Cash</strong></td>
<td>17,623,466.72</td>
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<td><strong>Stocks and Bonds</strong></td>
<td>$22,329,663.71</td>
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</tr>
<tr>
<td><strong>Real Estate</strong> (Other than Factory Plants)</td>
<td>118,063.34</td>
<td></td>
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<tr>
<td><strong>Notes and Accounts Receivable</strong></td>
<td>19,377,972.37</td>
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<tr>
<td><strong>Work in Progress</strong></td>
<td>462,223.41</td>
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<tbody>
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<td><strong>At Factories</strong></td>
<td>$21,610,283.91</td>
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<tr>
<td><strong>At General and Local Offices</strong></td>
<td>3,321,870.94</td>
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<tr>
<td><strong>Consignments</strong></td>
<td>217,880.98</td>
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<tr>
<td><strong>Factory Plants</strong></td>
<td>14,330,958.12</td>
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<tr>
<td><strong>Copper Mining Investment</strong></td>
<td>3,086,601.81</td>
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<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>5% Gold Coupon Debentures of 1892</strong></td>
<td>$40,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>3½% Gold Coupon Debentures of 1902</strong></td>
<td>2,947,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>5% Gold Coupon Debentures of 1907</strong></td>
<td>12,675,000.00</td>
<td></td>
</tr>
<tr>
<td><strong>Accrued Interest on Debentures</strong></td>
<td>83,664.58</td>
<td></td>
</tr>
<tr>
<td><strong>Accounts Payable</strong></td>
<td>2,753,617.30</td>
<td></td>
</tr>
<tr>
<td><strong>Advance Payments on Contracts</strong></td>
<td>777,133.24</td>
<td></td>
</tr>
<tr>
<td><strong>Dividend Payable, January 15, 1910</strong></td>
<td>1,303,592.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$19,880,007.22</td>
<td></td>
</tr>
<tr>
<td><strong>Capital Stock Issued</strong></td>
<td>65,179,600.00</td>
<td></td>
</tr>
<tr>
<td><strong>Surplus</strong></td>
<td>17,381,381.69</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$310,240,988.91</td>
<td></td>
</tr>
</tbody>
</table>

Source: Published Annual Report.
except for Patents, Franchises and Goodwill, approaches modern practices. Liabilities also show modern tendencies except that long term obligations were exhibited ahead of current debts.

The following quotation from the results of a survey of six industrial corporation balance sheets of 1909 by John Noons is doubtless typical of depreciation practices of that period:

National Biscuit Company allows annually a fixed sum—$300,000—although depreciation can scarcely be said to go on uniformly and irrespective of changes in the amount of permanent investment. American Car & Foundry Company charges against 'earnings from all sources,' for the year, 'renewals, replacements, repairs, new pattern, flasks, etc.,' but makes no specific reservation for depreciation. The Midvale Steel Company employs rates per centum based upon diminishing value. The New Home Sewing Machine Company apparently pursues a course similar to American Car & Foundry Company. The method used by the Butterick Company is not disclosed. . . . International Paper Company's report makes no reference to the subject beyond the statement of the president, that the plants have been "carefully maintained."19

Even prior to 1920 attempts were being made to increase the utility of financial statements by improved presentation. Most balance sheets made clear distinction between fixed properties and current or working assets. The prevailing practice was to show the fixed assets first followed by the working and current assets. Additional subgroups such as deferred charges and investments appear in various company statements. There is a distinction made between working and current assets in many statements at this time. Dickinson20 explains this difference by saying


that working assets are those which are not intended for sale but are consumed in the operations. Current assets, on the other hand, are being continually converted from one form to another in order to earn a profit and subsequently being converted into cash. This distinction while in use before and after the 1920's was mostly discontinued during this period and the heading "current asset" was used to include both types.

Dickinson gives an illustrative balance sheet as follows:

**Assets**

Fixed Property (after deduction of estimated depreciation due to use)
Permanent Investments
Working Assets (raw materials, supplies, prepaid expenses)
Current Assets (finished goods, receivables, temporary investments, cash)
Suspense Debits (bond discounts, organization expense, extraordinary losses)

**Liabilities**

On Capital Account (capital stock and permanent or funded debt)
On Unfunded Debt (for capital, as distinct from current purposes)
Current Liabilities (notes, accounts, provision for losses & contingencies)
Suspense Credits (to income or surplus)
Surplus (appropriated and unappropriated)

The preference status given to fixed assets was to emphasize the most important items, as to size, as this was presumably of greatest interest to those who provided capital. This was a natural carryover from British influence. Although American balance sheets differed from the British in that assets were shown on the left side, the British practice of showing fixed property first seems to have prevailed in American statements for a number of years. The arrangement of liabilities was made in a

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manner analogous to that of the assets as a matter of convenience. 22

Balance sheet practices as to contents, valuation, and presentation during these early decades differed from one company to another and from year to year. Although there was a lack of "generally accepted practices" as we know them today, vigorous efforts were being made by the American Institute of Certified Public Accountants, the Federal Reserve, and others to encourage greater uniformity in statement presentation and auditing procedures.

In 1917, the American Institute, working in conjunction with the Federal Reserve Board, developed a statement on accounting principles and suggested form for statement presentation. This work was published in the Federal Reserve Bulletin of April, 1917. 23 Several years later, in 1929, this study was revised and published by the Federal Reserve Board under the title Verification of Financial Statements. Foulke states, "It is evident from these two early studies toward more uniform and minimum standards of accounting that the contribution of the Federal Reserve Board by sponsoring this study was considerable." 24

Basic questions such as the proper status of the balance sheet on valuation were in a state of uncertainty. Dickinson, in his widely used book, Accounting Practice and Procedure, in 1918, maintained that the

22*Ibid., p. 44. Dickinson states that convenience rather than logic guides the arrangement because logic would require that liabilities to outsiders be shown first.


function of balance sheet was to ascertain the financial status of a firm at any given time. Appreciation or depreciation in the "value" of assets apart from normal operations (including those due to a rise or fall in prices) were to be reflected in net worth. Paton and Stevenson writing the same year similarly held that the balance sheet through "correct appraisals" produced an accurate presentation of the financial status of the business.

Hatfield, a recognized authority, writing some years later (1927), noted that the fundamental question of whether the balance sheet contained historical costs or present values had never been satisfactorily settled. This author held that the concept of present value, although generally accepted by accountants, was by no means always followed and historic cost was used in some instances. He argues that historical cost, if understood, may be just as accurate as present values. The balance sheet, he maintains, "might, and ordinarily does in part, disregard present values and present historic costs."

Roy B. Kester in his widely used textbook points out that the purpose of the balance sheet, i.e., securing capital from bankers, has greatly influenced the form of the balance sheet and the valuation of its contents. In performing its function of determining solvency and

25 Dickinson, op. cit., Pp. 31-44.


27 Hatfield, op. cit., p. 25.

soundness the balance sheet shows current assets on a cash basis and fixed assets on a cost less depreciation basis.

The position expressed by Kester seems to represent the majority procedure practiced during the 1920's. However, there was such pressure from business management to show fixed assets at appraised values, especially during the inflationary period of the late twenties. Practice during this period indicates that many firms did write up their fixed properties and this was sanctioned by accountants, provided the increase was carried to a special account such as Appraisal Reserve and not in the Surplus account.

As an example, the American Bakeries Corporation, on December 31, 1927, showed the following:

Plant and Equipment, Reproductive Value as at June 30, 1927, as appraised by the American Appraisal Company, plus additions since at cost

Less: Reserve for Depreciation

The published report of this company did not show any segregation of the Surplus account.

Some companies, such as General Cable Corporation, in its published reports included a parenthetical note on the face of the balance sheet showing the appraised sound value adjusted to date.

At least one company examined, Gimbel Brothers, Inc., went one step further and in its 1927 report showed the following:

Land, buildings and improvements—at values appraised by expert appraisers, Less depreciation

Less: Mortgage indebtedness

...
PART III
Recent Developments

During the early 1930's some firms adopted the policy of writing down fixed assets in an attempt to exhibit more realistic values on the balance sheet and reduce the depreciation charge against current earnings.

An example is found in the annual report of Remington Rand, Inc., for the year ended March 31, 1933. The company during that year went through a quasi-reorganization whereby it reduced the stated value of its common stock by some $15 million and at the same time reduced Intangible assets almost $6 million and Plant and Equipment over $2 million. As a result, the depreciation charge dropped about 33% from the previous year. Many firms, some of whom had recorded appraisal increases during the 1920's felt compelled to scale down fixed asset values in order to improve operating results.

In its quest to keep abreast of the increasingly complex business world and as a result of widely diverging practices the accounting profession felt the necessity of more clearly defining accounting postulates and improving auditing standards and practices. During this decade accounting theoreticians experienced a complete soul-searching. No rigid uniformity of rules and procedures resulted but great strides were made in resolving a body of generally accepted procedures in accounting and statement presentation.

In 1932 correspondence between a special committee of the American Institute of Certified Public Accountants and the New York Stock Exchange
expressed concern over general misconceptions about financial statements. Writers of text books were criticized for referring to the purpose of the balance sheet as being to reflect values of the assets and the liabilities on a particular date. The committee contended that the balance sheet was largely historical and that statements were based upon a body of conventions resting partly on theoretical and partly on practical grounds. The committee thought it highly important that investors and other users be informed of the basis upon which the accounts were prepared and be made aware of the consistency of the application of the methods employed.

In 1936 the American Institute of Certified Public Accountants, in recognition of recent developments in the direction of increased emphasis on accounting principles, consistent application thereof and fuller disclosure, issued a bulletin entitled Examination of Financial Statements. This bulletin reiterated the view that yearly appraisals of assets were impractical in the light of a complex, highly mechanized industry and would serve no desirable purpose. The most important accounting conventions were presented therein, and great stress was again laid upon consistent application of accounting principles.

The bulletin submitted a suggested form of financial statements which reflected the most desirable form at that time. The suggested


balance sheet appears as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets:</strong></td>
<td><strong>Current liabilities:</strong></td>
</tr>
<tr>
<td>Cash</td>
<td>Notes payable</td>
</tr>
<tr>
<td>Marketable Securities (state basis)</td>
<td>Accounts payable &amp; accrued expenses</td>
</tr>
<tr>
<td>Notes and accounts receivable</td>
<td>Advances</td>
</tr>
<tr>
<td>Less: Reserve for doubtful notes &amp; accounts</td>
<td>Provision for federal and state taxes</td>
</tr>
<tr>
<td>Reserve for discounts, freight</td>
<td>Other current liabilities</td>
</tr>
<tr>
<td>Inventories (state basis)</td>
<td>Total current liabilities</td>
</tr>
<tr>
<td>Other current assets</td>
<td></td>
</tr>
<tr>
<td>Investments (state basis)</td>
<td></td>
</tr>
<tr>
<td>Property Plant and Equipment (state basis)</td>
<td></td>
</tr>
<tr>
<td>Less: Reserve for depreciation</td>
<td>Funded deby (describe)</td>
</tr>
<tr>
<td>Intangible assets (describe)</td>
<td>Reserves (describe)</td>
</tr>
<tr>
<td>Deferred charges</td>
<td>Capital stock (describe)</td>
</tr>
<tr>
<td></td>
<td>Preferred stock</td>
</tr>
<tr>
<td></td>
<td>Common stock</td>
</tr>
<tr>
<td></td>
<td>Surplus:</td>
</tr>
<tr>
<td></td>
<td>Capital or paid in</td>
</tr>
<tr>
<td></td>
<td>Revaluation</td>
</tr>
<tr>
<td></td>
<td>Earned</td>
</tr>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
</tr>
</tbody>
</table>

The above statement was representative of general practice during the late thirties. A few industrial firms were still following the practice of showing fixed items first; however, this practice was largely confined to public utilities.

The above form has remained in wide acceptance, with little basic change, down to the present. However, the increasing use of the financial-position form of the balance sheet may be viewed as a trend away from the above form. There has been considerable agitation by many, including the American Institute, for revision or elimination of the Deferred assets and Reserves sections. Revisions in terminology have also been proposed by the Institute and others.

Other factors during this period have had important influence upon the presentation of financial statements. The Securities Act of 1933 and
the Securities Exchange Act of 1934, both administered after 1934 by the Securities and Exchange Commission, have had great influence upon the form and contents of accounting reports. Since the Commission was authorized to "prescribe" the form and contents of financial statements of firms under its jurisdiction for filing purposes, it exerted a tremendous influence upon statement contents for other purposes as well. The Commission in order to provide investors and prospective investors with informative, dependable statements required that statements filed be in accordance with sound and generally accepted accounting principles. In its early days the Commission found it desirable to provide certain reporting standards, which it considered sound and generally accepted, and in 1937 began to issue Accounting Series Releases from time to time to publish its opinion on accounting principles and procedures. These have differed at times with pronouncements of the American Institute but generally have served to stimulate refinement and development of reporting standards.

The American Accounting Association has also had considerable influence in developing accounting and reporting standards. Its first publication of this nature was A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements in 1936 which has been followed with several revisions and supplementary statements. Several monographs have been issued under its auspices including An Introduction to Corporate Accounting Standards in 1940 by Paton and Littleton.31

Although these publications have been said to favor the academic or theoretical view, they have had considerable effect upon accounting thinking and practice.

In addition to the above publication the American Institute in 1939 began issuing Accounting Research Bulletins from time to time to express what it considered preferred accounting practice. These releases have served as a guide to practicing accountants in controversial areas of accounting practice.

All attempts to determine recent developments in balance sheet presentation have been greatly facilitated by the annual publication, since 1946, of Accounting Trends and Techniques by the American Institute of Certified Public Accountants. This publication includes a detailed analysis of current practices in financial reporting.

The trends affecting the balance sheet indicated by this study over the past 10 years may be summarized as follows:

(1) There has been a decrease in the number of firms using the title "balance sheet" with an increasing popularity of the title "financial position." The title "balance sheet" is still used in the majority of statements.

(2) There has also been an increase in the use of the "financial position" form of the balance sheet, i.e., current assets less current liabilities, plus other assets less other liabilities, equal stockholders' equity.

(3) An increase in the use of such words as "allowance" and "provision" in place of "reserve" in showing doubtful accounts and depreciation. Also a decrease in the use of the term "reserve" in connection with tax liabilities.

32 Published by the American Institute of Certified Public Accountants annually.
(4) Increasing numbers of companies are using such titles as "stockholders' equity" or "shareholders' equity" to describe the owners interest. The term "capital" and "capital stock and surplus" are being used less frequently each year.

(5) There has been a steady decrease in the use of the term "surplus" in describing the "retained earnings" with terms such as the latter replacing the term "surplus."

(6) Marketable securities shown in the current asset section are usually valued at "cost" with information as to market value included.

(7) "Lower of cost or market" continues to be the most commonly used basis of inventory valuation. There is a trend to wider use of last-in, first-out as a method of determining cost and the survey revealed that this was the most frequently disclosed method of cost determination.

(8) There is a trend towards showing prepaid expenses as a current asset; however, the majority of companies still show these as non-current.

(9) "Cost" continues to be the most commonly used basis for carrying investments in, and advances to, unconsolidated subsidiaries and affiliated companies.

(10) The great majority of firms continue to show fixed assets at cost.

(11) Intangible assets are generally shown at a nominal value or cost less amortization.

(12) There has been a decrease in the use of the term "Reserves" in connection with items such as contingencies, insurance, etc., on the balance sheet. The survey reveals, however, that a majority of the companies with a contingency reserve presented it above the stockholders' equity section.
CHAPTER III

THE NATURE AND USES OF THE BALANCE SHEET

In evaluating the role of the balance sheet in financial reporting it is desirable to know the uses made of the statement. A study of the various functions performed by the statement is made in this chapter to illustrate how the demands of various groups, as well as changing traditions, have influenced the development of the balance sheet. The present characteristics of the statement are analyzed in the light of these several and sometimes conflicting influences.

Financial information exhibited through periodic reports is of vital interest to a heterogeneous group of users. Historically the balance sheet has been directed to a few creditors and owners closely related to the operations of the business. Modern developments have caused the balance sheet to be utilized by an ever increasing audience of users. Owners and management, once considered synonymous, comprise two distinct groups in present day corporate enterprises. Information needed by (outside) owners differs from that intended for internal consumption. In recent years financial reports have become of tremendous importance to many hitherto unconcerned groups, such as labor and labor organizations, regulatory agencies, taxing agencies, national income study groups, consumers, competitors, and the community in general.

MULTIPURPOSE USES OF THE BALANCE SHEET

Economic advances in our society, more enlightened groups, and the greater availability of information have caused a far more extensive
as well as intensive use of financial reports. The first half of the twentieth century may be characterized as the era of the corporation and big business. As the influences of the large enterprises have been felt more and more in our economy, great interest in their development and operation has been generated from all sides. Accounting assumed the normal responsibility of providing financial information to this heterogeneous group of users. An analysis of the more important users and uses of financial reports follows.

Credit Grantors

The preparation of financial statements, especially the balance sheet, first came in widespread use in this country largely as a result of the demand of the bankers and others when advancing credit. These credit grantors had specific things in mind which they expected the balance sheet to reveal. Of prime concern to them was the nature of the relatively liquid funds, i.e., cash or items readily convertible into cash, and the nature of outstanding short term debts. The value of these funds which had significance was their "pounce" value, or the amount of cash which could be realized in case of financial distress. The banker could assess the safety of a proposed loan by a knowledge of this minimum amount of liquid funds available to repay the obligations and by his first hand knowledge of the firm and its owners.¹ The income statement was seldom required and was regarded as having limited usefulness when determining the safety of a loan, especially a short term loan.

¹"The owner was not deceived, since he knew his business intimately — bankers disregarded all values except current assets and rested secure that they were at least as good as represented," Kenneth MacNeal, "What's Wrong With Accounting?",II, The Nation, (October, 1939), 110.
Early American balance sheets reflected this heavy emphasis on conservatism and the pounce value method of asset determination became the accepted procedure. George O. May, writing in 1943, made the following statement as a broad survey of the changing emphasis in accounting:

Again, forty five years ago the external influence on accounting that had the greatest effect was that of the credit grantor. In recent years there has been a marked shift of emphasis, and the use of accounts as a guide in the purchase or sale of securities has been more heavily stressed as a result of the efforts to impart liquidity to investments in long-term enterprises. In the early days, conservatism was the cardinal virtue of accounting; now, the virtue of conservatism is questioned, and the greater emphasis is on consistency.2

Owners

Another important factor responsible for the development of the balance sheet has been the gradual separation of ownership and active management. Many early American businesses, when under the control of the original founders, kept few accounting records and never produced formal statements except when required for credit purposes. These early pioneering businessmen had intimate knowledge of their operations and exercised close personal supervision. Records were thought to be superfluous and reports were mistrusted. The fear of divulging information to competition helped to keep published reports at a minimum. Progress or lack of it was judged by physical inspection and was very closely tied to cash.

Subsequent growth in size and complexity of enterprises laid the groundwork for the advent of accounting records and reports. Increased

size made records essential to communication and control. The need for additional capital led the way to periodic statements to inform investors on the status of the enterprise. These early reports to the few "inside" investors were designed to reveal the status of the business in a highly conservative fashion. The creation of secret reserves, that is, the understatement of and omission of assets, was generally accepted as virtuous. The cash realization value of the assets which were included constituted a maximum level of valuation for many of the assets. Resources which did not contain immediate debt paying power were generally omitted from the balance sheet. This practice was not intended to deceive—on the contrary this was the type of report desired by the few who had access to reports of any kind.

Further growth and development eventually required business enterprises to seek capital from investors at large. Thus a distinct break began to take shape, i.e., severance of ownership from active management. This phenomenon presented one of the greatest challenges to accounting. Not only did increase in size and complexity necessitate voluminous data for internal operations and control, but accounting reports became the principal media by which the owners could evaluate their investment, management, and managerial policy.

Since the nature of accounting is evolutionary, this gradual change in economic enterprises was accompanied by some changes in accounting. Financial accounting had a tendency to direct itself towards accounting to the stockholders—providers of capital. Accounting did not experience an abrupt change in attitude, for example from banker and owner-manager viewpoint to investor viewpoint. Many of the basic characteristics were carried over and adapted to the new focal point of
accounting. Valuation of assets on a liquidation basis and the acceptance of conservatism as transcending all other objectives still exerted great influence on financial reports. The more obvious abuses of secret reserves began to receive vocal criticism as being misleading to outside owners. This was perhaps the first example of a practice which became undesirable as the function of the statement changed or as new groups began utilizing accounting reports. It took, however, many years and persistent criticism to eradicate the more serious abuses of secret reserves.

The balance sheet is now considered by some to be management's stewardship report to the providers of capital. Its function is accordingly that of revealing use and disposition of funds which have been intrusted to management. This view is frequently advanced to support the invested cost theory as opposed to the replacement value or other current value bases. Reporting on the funds placed in management's responsibility and revealing how well or poorly management has met this responsibility is frequently of great concern to owners. Precise means of achieving this objective, however, are still subject to widely differing opinions.

Perhaps the most important function of the balance sheet to stockholders is its use in determining the effective earning power of their investment. Relating income to investment serves as an objective guide to owners in measuring the performance of the enterprise to which they have entrusted funds or in which they have acquired an interest. This area of financial statement interpretation is receiving widespread attention today. It is a function in which both management and owners alike are vitally concerned.
Management

Management uses of the balance sheet are necessarily closely related to those of stockholders because of similarity of their interests. Management's utilization does extend further to include everyday use of financial data in operation of the enterprise. The current asset-current liability relationship and the control over the flow of cash are of utmost importance to financial management. Financial information used by management must be current and dynamic; for example, cash on hand is a useful factor when combined with expected receipts and disbursements over the ensuing period under consideration. The form in which this information is used by management in operations is seldom in the nature of a formal balance sheet, since operating executives are concerned with different segments of the financial structure at different times.

As indicated above, there is much emphasis on the rate of return as an aid to management in decision making. The uses of the return on investment computation are classified by Harold Bierman as (1) measuring results of operations and (2) decision making. Under the latter classification he includes price decisions and capital rationing decisions, such as equipment replacement, capacity expansion, research, buying versus leasing, make or buy, and introducing new lines. This managerial tool is fraught with limitations unless extreme care is used in arriving at a meaningful basis which is consistent with the return to which it is related. As emphasized by Bierman, "many of the problems of measuring

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average investment in connection with computing the return on it are directly related to the problem of income measurement. 4

Security Analysts

In addition to the groups mentioned above, security analysts are probably more concerned with financial statements than any other group. Security analysts are normally acting for someone, frequently creditors and investors, and therefore, the uses which they make of statements coincide closely with those of the latter groups. Security analysis involves much more than an interpretation of annual reports, however, these published reports constitute a major source of the information available. The recommendations of this highly skilled group are influential in the majority of investment decisions. In performing their function they rely heavily on the representations which the accountant and accounting reports purpose to exhibit. This group is keenly interested in improved reporting standards and increased reliability of financial statements.

The uses which this group makes of financial information vary widely according to the needs of the clients. Financial reports are carefully analyzed, sometimes recast into different reports and schedules, to reveal the information desired in each particular circumstance. Hence, this group is primarily interested in complete disclosure of all material data which might influence investment decisions.

Public Agencies

Governmental agencies have demanded an increasing amount of financial information from business. Regulatory bodies have for many years

4 Ibid., p. 77.
executed their assigned control functions largely through scrutinizing financial reports, whose forms have been prescribed or influenced by these agencies. The advent of federal income taxation placed an additional burden on accounting information. Accounting reports in addition to providing information to the investors must now also in many cases, provide the basis for the tax levy. There have been considerable efforts in the past, and still continuing, to make tax regulations conform more closely to what is regarded as good accounting practice. Benefits from these efforts if successful would not only make the tax more equitable, but would also permit the use of conventional statement information for tax computation purposes with little or no changes. This assumption is apparently being made by the many who advocate that accounting methods should be changed in an attempt to change or reduce the amount of taxable income.

Tax authorities require that the income produced by the accounting records conform to the many requirements of tax regulations or at least that the accounting information be adjusted to reflect taxable income. The universal nature of income taxation has caused a tremendous increase in the number of firms maintaining accounting records. As a result, the accounting procedures have frequently been those which produce the lowest tax base and meet the requirements of the revenue service. This influence has also crept into the accounting systems of large organizations whose tax filing requirements are supplementary to maintaining adequate accounting records.

In several instances, notably in the case of last-in, first-out method of inventory valuation, the acceptance of an accounting procedure by the taxing authorities has lead to widespread use and frequently to
"general acceptance" of such procedures. A similar situation exists in the case of the recent acceptance, for tax purposes, of declining balance depreciation. This accounting method, while frequently logical and useful for some purposes, is used in almost all instances without explanation, regardless of whether or not it is realistic under the circumstances. The adaptation of accounting information for tax computation purposes has hence resulted in the use of this information for all other purposes as well, because tax accounting has gradually crept into general-purpose reports. In fact, there is a general reluctance on the part of businessmen and many accountants to accept any change which is not sanctioned by the tax authorities.

Employees and Labor Organization

Organized labor has become a major user of financial information. Labor has learned that enlightened and effective negotiations are based, among other things, on a reliable knowledge of the financial status and earnings of the companies involved. Many union leaders feel, of course, that information which management furnishes them is too meager and too summarized. Labor is interested in a detailed breakdown of cost, especially labor costs in relation to other costs, and its relation to revenue. In judging "ability to pay", which is a basic factor in all wage negotiations, organized labor is vitally interested in the earnings in relation to the invested capital. This point was emphasized in a research report of the American Federation of Labor as follows:

For union purposes, the rate of return on net worth is a far more reliable and accurate indicator of profits than the rate of return on sales . . .

Much of the discontent on labor's part with available information involves a conflict as to the amount of detailed data labor is entitled to have. Beyond this, however, labor is generally distrustful of financial reports, which it claims are directed towards the owners and designed to conceal profits and reduce taxes. There is an acute problem as to whether an improved general purpose report or whether a specialized report would more adequately meet the needs of this particular group of financial data users. The following quotation from Lane Kirland, member of the research staff of the A. F. of L., throws some light on this problem from labor's point of view. He makes the following observation:

In a general sense, we (labor) are interested in the same facts regarding the operations of a business as are stockholders and others, with a few more breakdowns needed to give more detail on certain items more closely related to the worker's part in the business.

The increasing use of financial reports by employee organizations places an additional burden on accounting to produce objective, reliable financial information in a manner that it will appear thus to labor. For example, improvements in terminology and more consistent use of terminology, especially in the area of reserves, would greatly enhance labor's confidence in accounting reports. There is of course a tremendous job of education as to the significance of and methodology used in accounting.

Economists

Economists as a group have long been concerned with financial reports of business enterprises as a principal source of data for empirical analyses. This specialized use of accounting data requires that the

6Ibid., p. 372.
published reports be adjusted to reveal the information in the desired form. Accounting may be able to perform its function more effectively in this area by producing a full disclosure of financial data in a consistent manner so that various analyses can be made from the data.

In addition to the use of financial data for national income and other analyses there is current interest in the compilation of a National Balance Sheet.

This device is designed to measure the assets and liabilities of the whole economy and of its various components. Such new and specialized uses of the balance sheet places additional responsibility upon accounting. Inconsistent standards for determination and valuation of balance sheet assets as now exist in many areas will not contribute to greater utility of accounting reports.

**NATURE OF PRESENT BALANCE SHEET**

The present balance sheet may be examined in the light of the varied influences and factors noted above. The many uses made of financial statements and the changing emphasis in financial reporting have resulted in the present day structure and contents of financial reports.

The balance sheet has evolved to include an array of unexpired costs, monetary resources, and liquidation-valued assets and these are equated with maturity-valued claims, original owner investment and retained earnings. The statement does not represent nor is it intended to represent the sum total of invested costs, nor the present market or reproduction value of the resources, nor the value of the enterprise in

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7 "Now the Trick is to Blend Them," *Business Week*, LXX (Nov. 2, 1957), 61-64.
case of liquidation. The assets admitted for balance sheet purposes contain rather a variety of items whose values have been determined by means of various assumptions and objectives. The equities represent a group of claims and rights. Liability claims, i.e., generally those with definite maturity date, are stated usually at maturity value. Residual ownership interests are stated partially at legal amount invested and partially at the amount of accumulation of computed income which has been retained since inception.

An examination of the major subclasses on the balance sheet will be made to show how various forces have tended to influence particular sections of the balance sheet.

**Current Assets**

The current asset section largely reflects the influence of showing realizable values for credit purposes. The long term practice of emphasizing the value of current resources in evaluating credit strength has made this section subject to the realization approach of asset determination. This class has by tradition included only those assets which could be expected to be converted into cash within a short period. Cash and claims to cash are currently shown at face or cash-equivalent value. Short term securities are frequently shown at cost or market whichever is lower. The excess of the market value of the securities over cost however, is generally not acceptable as balance sheet value nor is it a proper item of income. Receivables are usually stated at nominal amount realizable less estimated uncollectible claims. Inventories, frequently the most important item as to size, are normally stated on a lower of cost or market basis. Writing on some of the
problems of inventory valuation, Garner states,

As long as the current asset aspect of inventory predominates, with its emphasis on liquidation to satisfy creditors, attention will be given to the use of replacement cost, or 'market', in connection with the stating of the inventory on the balance sheet. 8

The recent shift in accounting emphasis from balance sheet presentation to income determination has caused some revision in the application of the historical cost or market rule. In Accounting Research Bulletins No. 43 the American Institute of Certified Public Accountants states the following:

The rule of cost or market, whichever is lower is intended to provide a means of measuring the residual usefulness of an inventory expenditure ... In applying the rule, however, judgment must always be exercised and no loss should be recognized unless the evidence indicates clearly that a loss has been sustained ... The purpose of reducing inventory to market is to reflect fairly the income of the period.”

The American Accounting Association in its Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948 Revision, states,

The residual cost should be carried forward in the balance sheet for assignment in future periods except when it is evident that the cost of an item of inventory cannot be recovered, ... In such event the inventory item should be stated at the estimated amount of sales proceeds less direct expense of the completion and disposal.

Since the beginning of World War I, many firms have adopted the last-in, first-out method of determining cost for inventory purposes.


This development has been motivated by the expressed desire to match current (replacement) costs with current revenue, to reap substantial tax benefits, and to accommodate management in discharging its functions such as dividend declarations, wage negotiations, and product pricing.10 The use of the LIFO method during periods of rising prices has resulted in including in current assets for balance sheet purposes an item at an amount which is completely unrealistic and inconsistent with other items. In spite of the advantages claimed for this method in the area of income determination, it is certainly misleading for most uses made of the balance sheet and distorts analyses and ratios made using the current asset section. Until recently, prepaid items, such as the cost of an insurance policy applicable to a future period, were not admissible as a current asset. The reason was that these items have little or no value in case of liquidation.

The contents and valuation of current resources still exhibit a heavy bias towards the needs of the credit grantor, especially the short term credit grantor. The uses made of the report have changed or at least broadened considerably over the years, however, the contents and valuation of current assets have not changed materially.

**Fixed Property**

Fixed assets undoubtedly have attracted more attention and controversy, and have perhaps experienced less change in practice than any other section. This group has traditionally represented the bulk of the stockholders' investment. Emphasis here has been in reporting to the

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owners and long-term investors on the nature and amount of the fixed property. The most important information has generally been considered to be the cost of the property. For many years, up to the turn of the century, it was common practice to continue to report the investment at cost, i.e., depreciation was not recognized. After the advent of depreciation the practice of showing asset cost less accrued depreciation became standard procedure. The inflationary period after World War I and the subsequent depression caused some change in the method of reporting fixed assets. Some firms wrote-up their fixed property during the period of high prices in an attempt to reflect current values in the balance sheet. The depression of the thirties brought opposite reactions and many firms adjusted their records to reflect lower-than-cost figures on the financial statement.

Since the start of World War II there has been much widespread agitation to reflect higher-than-cost values for fixed assets on the balance sheet. Attempts to record appraisal increases on the financial statement have generally been discourage by several factors. Auditors have refused to render unqualified opinions on statements where appraisal increases have been entered in the records. Tax authorities have of course refused to permit depreciation of appraisal increases to be deducted for tax purposes. Consequently, very few firms incorporate appraisal increases in their records and some of the firms which did embark on this program later recinded their action.¹¹

¹¹ For example, General Electric.
Most accounting authors and organizations have recommended that cost be maintained in the basic records but that the statements be supplemented to reveal the effects of price level changes. Many have urged that the accountant should include a set of supplementary statements converted to a common dollar by use of index numbers. A general survey of some of the published reports does not indicate that there has been any change in this direction.

The primary influence in this area continues to be the cost of the property and its allocation to revenue. Interest is directed to reporting to owners and long term investors as to the use and disposition made of the bulk of their fixed investment. Cost as the most objective representation of value at acquisition has been accepted as the original measure of the acquisition. Subsequent charges to operations have, as indicated above, generally been based on original cost. The traditional view has been that once the original measure of the asset has been established there is no need to change. These assets, it is maintained, are held for consumption through use and are not held for resale; hence market value is not paramount. Serious criticism has arisen from those who advance that depreciation charges based on historical cost are entirely unrealistic now that the value of the dollar has fallen so drastically (approximately 50% in the last two decades). They argue that matching such cost with current revenue dollars results in grossly misstated income computation. In spite of these many attacks on the historical cost concept, it is still almost universal in application.
Other Non-Current Assets

Investments in securities of other firms and various investments held for income or capital gain purposes have generally been recorded at cost on the balance sheet. These usually constitute a small portion of overall property except in case of holding companies where they become analogous to the fixed plant.

The complex area of recognition and valuation of intangible items has been subject to various treatment. The tendency for conservatism resulted in numerous instances of arbitrary write off of the cost of intangibles. Creditors in general have been skeptical of this group of assets, undoubtedly because of their lack of value in case of liquidation. Owners in the past have harbored the idea that "doubtful" assets should be removed as soon as possible, especially if earnings were sufficient. The distortion which resulted in the current reported income and in future income was not considered of major consequence. The resulting balance sheet was acceptable primarily because it was conservative.

These underlying factors have influenced accounting practice relating to outlays for intangible rights. Accounting has sanctioned fast write offs in the past and today the practice is still widely followed. This influence has carried over into the area of promotional costs for new products, vast marketing research costs, developmental and production research costs, and large scale advertising outlays. These huge spending programs do not result in tangible commodities and hence they are generally considered period costs. As a result current and future income statements and balance sheets are distorted and attempts to relate reported income to invested capital are seriously hampered.
Current Liabilities

Current liabilities have generally been restricted to those claims arising out of, or requiring satisfaction from current assets. These obligations have traditionally been shown at face value. The practice of showing face value is usually defended on the basis that liquidation will occur in a relatively short period, frequently within 60-90 days. The discrepancy which exists between present and maturity value may not in all cases be material in amount, however, consistency within the statement would be improved if present values were exhibited. The one year rule has presumably been adopted as a convenient time period to distinguish between current and non-current claims. Though this rule is still widely followed, the American Institute of Certified Public Accountants, has proposed that the length of the operating cycle be used when longer than one year. This is a step forward towards a less arbitrary dividing line between current and non-current items.

Fixed Liabilities

Long-term obligations following the procedure used in the case of short-term debts are usually recorded at face value, i.e., maturity value of principal. The discrepancy between present value and face is usually of material amount because of the time and amount involved. In the case of bonds issued at a discount for example, the result is an overstatement of liability and overstatement of asset, whenever such discount is shown as a deferred charge. The tendency to make the financial statement conform to the legal characteristics of the obligations has contributed to the present custom of recording liabilities. Undoubtedly the fact that creditors were usually interested in the full amount of their claims in case of dissolution has also influenced present practices. It is
true, of course, that creditors must look to current operations of the
going concern for the satisfaction of their claims; however, tradition
and custom have accounted for the still-existing emphasis upon the
presently-held assets and the maturity value of their claims.

Reserves

Although the so-called reserve section of the balance sheet has
received the almost universal criticism of texts, articles, and pronounce­
ments, the practice of showing it on the statement still persist in many
instances. In the past, excessive and arbitrary reserves were frequently
created to understate (or overstate) income and produce fairly stablized
reported earnings. Reserves that appear today are still to a large
degree the result of subjective managerial decisions. It is frequently
difficult for the reader to determine if the reserves represent valid
obligations or if they are merely appropriation of retained earnings.
Thus the traditional practice of presenting a conservative statement has
carried over with the resulting effect that present statements are con­
fusing and misleading.

Proprietorship

The proprietorship section of the corporate balance sheet reflects
a heavy emphasis on legalistic requirements. Much consideration is given
to par or stated value of stock although this information may have little
or no significance outside the legal realm.

Accounting has attempted to show the basic sources of proprietary
interest. Investment by stockholders (plus earnings subsequently capita­
lized) is usually broken down between par or stated value of the shares
and the excess over par or stated value, usually called paid-in surplus.
Retained income is usually exhibited as one amount or sub-divided between
that portion which is earmarked (appropriated) and that portion which is unencumbered. In some instances the amount represented as par or stated value of the capital stock does not coincide with the legal capital established by the incorporating state. Since accounting cannot, except in the simplest situations, reveal the legal intricacies it would perhaps be desirable to use some other basis for classification within the proprietorship section.

Accounting theory and practice has traditionally made a clear distinction between creditor interest and proprietary interest. As a result preferred stock has always been considered part of the proprietorship although it has many of the characteristics of long-term obligations and fewer characteristics of common stock. For many purposes, a reclassification of preferred stock, especially when it is nonparticipating and subject to call, would produce a more significant classification of equity groups. Since preferred stock with the above mentioned characteristics, is frequently excluded from the analysis and interpretation made of the owners' equity section, separate classification would seem more appropriate.

Summary

The balance sheet as it has evolved through the years is largely the product of historical and traditional tendencies. Early reports in attempting to supply the needs of the credit grantor resulted in highly conservative, liquidation-value statements. Subsequent use of financial information by owners and absentee-owners tended to cause statements to report on the nature of the invested capital. This tendency was superimposed over the earlier highly conservative influence. The use of accounting information as a basis of tax reporting and tax computation
was another factor which influenced the contents and valuation of the balance sheet.

Modern developments have resulted in a host of new groups making use of financial information. Accounting has attempted to modify the reports or parts thereof to meet the needs of the majority of users. Improvements and modifications have all come within the sphere of influence of past traditions and customs.

The balance sheet which has resulted fails to satisfy the needs of all users nor does it completely meet the needs of any one group. The working capital items (current assets and current liabilities) are largely directed towards supplying the data desired by the short term credit grantors. Long term property is valued to reflect the disposition made of the investors' funds. Most other assets are determined and valued according to earlier traditions when the balance sheet was directed towards a few insiders. Liabilities have traditionally been shown at maturity value and have been heavily influenced by legal details.

The owners' equity has been influenced in its development from the proprietary viewpoint to the entity viewpoint (in the corporate enterprise) by the traditions of the former. Early attempts to reflect the residual equity in the corporate form reflected largely the legal framework of the entity itself. Thus for example, assets were sometimes inflated to correspond to the "legal" amount of reported owners' equity or liability.

Subsequent efforts (see Chapter IV) in improving the accounting determination of income were imposed upon this underlying structure. Commendable efforts at refining income through the matching of revenue with expired costs have been hampered by the persistent traditions of
the past of valuing some assets without regard for this principle, 

valuation with some other objective in mind.
CHAPTER IV

THE INCREASING EMPHASIS ON INCOME DETERMINATION

The increasing emphasis on income determination is probably the most significant development in accounting during the first half of the current century. This force has influenced all areas of accounting including the balance sheet. The influence of this change in emphasis is analyzed in this chapter to determine what changes should be made in the balance sheet to further the over-all goal of financial accounting.

The Change in Emphasis

The "increasing tendency to regard the main objective of accounting to be that of determination of periodical net income" noted by Thomas York in 1940 was an easily discernible phenomenon by that time. The tendency had begun more than a decade earlier. This basic shift in emphasis was undoubtedly caused by many different factors.

The rise of the modern corporate form with the separation of management from ownership was a prime factor in the growing emphasis on income determination. This was in contrast to earlier influences when the major function of accounting statements was to provide information for credit evaluation. Creditors were assumed to be primarily interested in the financial position of the borrower. The balance sheet was deemed

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sufficient to fulfill the need, and its contents were designed for this purpose. In the early decades of the current century the growth of the corporate form tended to shift the spotlight to the providers of equity capital. This group was interested not only in the given amount of periodic equity but also in the details of the factors contributing to growth or lack of growth. Gilman, writing in 1939, made this interesting comment on the shifting emphasis:

While the creditor's right are still considered of great importance, the stockholder, who was previously the forgotten man of finance, has found champions who insist that accounting owes an obligation not only to him who supplies temporary capital but also to him who supplies permanent capital.2

The owners as a group were vitally interested in the earnings of the enterprise as exhibited through an income statement. The profitability of their investment, the prospective return on their investment through dividends, the efficiency of the management, and indications of growth possibilities could be conveniently presented through an income statement. The stockholders, removed from the day to day operations or knowledge of the firm, had a natural tendency to seek data that would convey more useful information in simpler terms. The need certainly was understandable as well as universal. A single gauge of value, if one could be developed, certainly held (and still holds) tremendous appeal to the bewildered investors looking for a simple solution to the problems of where to invest his funds.

Accounting responded to this new demand by placing greater emphasis upon the income statement. Methods of income determination were at first

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somewhat crude, but major efforts were later aimed at refining the computation of income. Gilman summarized the effect of the investor’s viewpoint as follows:

The awakened interest in the investor’s viewpoint has constituted a most important force, tending to shift accounting emphasis from the balance sheet to the profit and loss statement.\(^3\)

Closely related to the above developments was the widespread interest in reformation in accounting which followed the market crash of 1929.\(^4\) The turbulent pre-depression days of frequent and optimistic revaluations of assets, dividend distributions based on inflated values, and heavy reliance on book value of stock, led naturally to a loss of confidence in the balance sheet and to a desire for something new and more reliable.

Another factor contributing to the greater emphasis upon income determination was, according to Gilman, developments in cost accounting.\(^5\) Newer concepts of cost transferability (from various expenditures to a product), improvements in cost allocations, and continuous tracing of cost through the accounts were all improvements aimed at sharpening the costs computation which aided in a more meaningful determination of income.

The 1913 Income Tax Amendment was a significant factor in the shift towards the income statement. The levying of a tax upon income naturally focused widespread attention on the problems of income determination. As the rates increased and the tax basis broadened, more and

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\(^3\)Ibid., p. 28.

\(^4\)Ibid.,

\(^5\)Ibid., pp. 28-29.
more firms and individuals became tax conscious and greater interest was directed to income. This may be viewed as a segment of the long term shift from property to income as a measure of well-being (wealth) and power. The trend in taxation has followed this change and the property tax has long since given way to the income tax as the primary source of total governmental revenue.

The increased emphasis on income caused by the advent of taxation has not always resulted in improvements in income computation. Undoubtedly, however, by placing the spotlight on income this factor has created interest in the area and has resulted in many refinements.

Greater emphasis on reporting to stockholders as outside owners, was perhaps the most important factor in the shift from the balance sheet to the income statement. The balance sheet presented to the stockholder several months after the close of the accounting period held little fascination. The activity report of income earned during the past period was considered more dynamic. Income earned reported on the statement constituted a much simpler and more easily understood yardstick of progress to the investor.

Evidence of the Change

The basic change in emphasis which has taken place during the past quarter century is clearly evident in the literature and in published financial statements. It is interesting and informative to trace some of the evidence of this change.

Perhaps the most typical expression of the viewpoint commonly held prior to the change is from Couchman's notable book published in
1924. Couchman observes that:

Among the many kinds of financial statements which confront the man in business today, the balance sheet holds the most important place. Nearly all other financial statements support it or are based upon it, or in some other way are reflected in it.\(^6\)

Accounting thought and practice soon reflected the revolution which was taking place. By 1937 May declared that income determination "is now generally recognized as the most important single problem in the field of financial accounting."\(^7\) The change in emphasis was given official sanction by the American Institute of Certified Public Accountants. In its first *Research Bulletin* in 1939 and again in 1953 the American Institute stated that "with the increasing importance of the income statement there has been a tendency to regard the balance sheet as the connecting link between successive income statements."\(^8\)

The change was quite evident in the text-book field as well. Paton, introducing one of his more famous works stated that,

The statements, the balance sheet and the income sheet, respectively, present the results of the entire accounting process. In a study of the theory of accounts, the income statement is of little importance, showing as it does an elaboration of an element finally incorporated in the balance sheet. The balance sheet, the financial summary, on the other hand, is of the utmost consequence for our purpose.\(^9\)

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In his last major publication Paton observed that,

The income statement is the accountant's major report of activity. The position statement shows financial status but the income statement is a performance report; it is the record of periodic operation, with the focus on earnings. The power to earn is the most significant characteristics of a going concern as opposed to a lifeless aggregation of assets.10

It should be mentioned, however, that Paton is not one of the many who consider that the balance sheet should be ignored entirely. He is quite outspoken on this particular issue. The following quotation attests to this fact:

...the income statement and the position statement are complementary presentations, and both are necessary to a proper financial reporting. In view of this fact any discussion aimed at deciding which statement is the more important is fruitless.11

Evidence of the change, although subtle, is also apparent in the widely used principles text written by McKinsey, later by McKinsey and Noble, subsequently by Noble, and currently by Noble and Niswonger. The first edition, published in 1929, characterized the balance sheet as "one of the most important statement he (proprietor) receives."12 This observation was repeated in the revised edition of 1935. In the 4th edition, however, published in 1945, the above quote was omitted when describing the balance sheet. In describing the income statement the author observed that "the amount of profit or loss incurred during a


11Ibid., p. 363.

given period is the most important single fact of the period."

Published financial statements for the last few decades also witness the change which has been taking place. During the latter part of the 19th century and the earlier part of the current century many firms did not include an income statement with their published reports. Some included an income account in rather crude form. The tendency during the past few years has been to place greater and greater emphasis on the income statement. In recent years, all firms, except banks and financial organizations, not only include but highlight the income statement as the most vital part of their reports.

A brief survey of some of the older annual reports available reveals the following information. Although information as to total sales and net profits was supplied many years before, U. S. Rubber first included a Statement of Income and Surplus, as such, in its 1928 report. In its second annual report in 1894 General Electric presented a Statement of Profit and Loss arranged in account form with debit and credit sides. This report highlighted a discussion of the valuation of assets, reassuring the stockholders that all assets were conservatively valued. In its 1930 annual report General Electric presented on the first two pages data as to earnings past and present. In its 1955 report, needless to say, the financial highlights consisted of sales, income taxes, and net earnings.

Some of the Effects of the Change in Emphasis

It is generally agreed that the most significant development in accounting in recent years has been the increased emphasis upon income. The effects of this force upon accounting have been far-reaching. The continuous efforts at sharpening the determination of income have
highlighted the function of accounting of measuring efficiency of operations and serving as a guide to investors' actions. These efforts have coincided with and were doubtless greatly influenced by the basic revolution taking place in American industry. This revelation witnessed the growth of large scale enterprises, which were operated by professional management, and which utilized funds provided by investors who had to rely heavily upon accounting data to evaluate their investment. These efforts have coincided with and were doubtless greatly influenced by the basic revolution taking place in American industry. This revelation witnessed the growth of large scale enterprises, which were operated by professional management, and which utilized funds provided by investors who had to rely heavily upon accounting data to evaluate their investment.13

Commenting on this fact the American Institute of Certified Public Accountants in 1939, and reiterated again in 1953, stated that:

... the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer and seller of an interest in an enterprise... The fairest possible presentation of periodic net income, with neither material over-statement nor understatement, is important, since the results of operations are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers.14

The going concern concept received greater recognition as a result of this new emphasis. The firm was considered to be a continuous stream of activity instead of a series of annual ventures. This change caused a reappraisal of the liquidation-value view of assets. Under the going concern concept expenditures were assumed to have been incurred with a plausible objective in mind and hence, arbitrary periodic revaluations with an imminent liquidation in mind were precluded.

13 William A. Paton in "Recent and Prospective Developments in Accounting Theory," Business Research Studies Number 25, (Boston, Mass.: Harvard University Bureau of Business Research, 1910), stated: "the increasing consideration being given to income measurement and reporting is presumably a manifestation of the influence of the business enterprise, managerial point of view.

The most far reaching effect of placing major emphasis upon income determination has been to bring the matching concept to the fore. The matching of expired costs with revenue became, in fact, the accounting concept of income. Income as a resultant of the matching of efforts and accomplishments has become the gauge of business progress. The matching concept has not only improved income determination but it has also rationalized the determination of many of the balance sheet assets and liabilities. The whole area of accrued assets, accrued liabilities, prepaid assets, and unearned income has largely resulted from the application of this principle.

The new era in the development of accounting has emphasized the importance of consistency in the application of various procedures. Evaluation of the activities of an enterprise over a number of years (accounting periods) has made consistency essential. The American Institute of Certified Public Accountants has expressed the opinion that the consistent application of a procedure may be more vital than the original choice of the procedure. This focus on consistent application has arisen as a result of the period convention, i.e., dividing the life of the enterprise into arbitrary segments, usually one year. Comparison of activity and performance of succeeding periods demands that there be consistent application of procedures. Any other avenue would open the statements, especially income, to manipulation by management and obscure their usefulness.

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Another highly desirable effect of the emphasis on income determination has been a rejection, in many cases, of conservatism as desirable per se. The illogical results of this accounting convention became clearly revealed when attempts were made to compare successive income statements. It became apparent to most that the conservatism convention was frequently in direct conflict with the matching principle.

Comparability of financial data became a cardinal standard as a result of the increased emphasis on income determination and the expressed objective of supplying data to the holder of, and the prospective investor in, corporate securities. The above mentioned concepts were all tempered with this objective in mind. Great strides have been made in this area and continued search is essential to continued success.

The Case for a Reappraisal

A very significant statement by the dean of American accounting authorities appears appropriate at this point. William A. Paton, commenting on the relative importance placed on financial statements said:

With the increasing emphasis on income measurement in financial accounting there has been some tendency in recent years to glorify the income statement at the expense of the statement of position, but this attitude is not warranted. Both statements are indispensable, and hence are equally significant. This is true even in the area of determining the degree of success achieved. The income statement shows the amount of earnings but this figure must be related to the amount of investment or resources employed to find the income rate, the true index of earning power.16

As discussed above, developments and improvements in accounting as a result of the greater interest in income determination have been welcomed and further improvements are vital. These advances have been a tribute to accounting efforts to make progress in the supplying of

16Paton and Paton, Corporate Accounts and Statements, p. 363.
needed and useful data. The spotlight placed upon the income statement was a natural phenomenon of the times and a result of accounting's principal effort to supply data for investment decisions and management evaluation.

These developments have gathered such great momentum that other parallel and equally deserving developments have been lost in the shouting. Too often the assumption has been made that since the income statement has increased in importance, of necessity, the balance sheet must have decreased in (absolute) importance. William W. Werntz, writing on the "resurgence" of the balance sheet made this observation.

It has been popular in recent years to maximize the importance of the income statement and to direct most of our efforts towards its improvement. In some cases, this has been done at the expense of the development of the balance sheet as a useful and important statement. There is, however, some evidence that the pendulum is gradually swinging in the other direction. 17

It is the thesis of this study that developments in the sharpening of income determination have been salutary, but a continued imbalance in emphasis is undesirable. Developments in the area of measuring and reflecting financial position should be made concurrently with those in income determination in order to achieve greater utility—the raison d'être of accounting.

The emphasis upon the income statement has tended to obscure the relationship of the two financial statements. It is too often intimated that the "balance sheet viewpoint" and the "income viewpoint" can be and

are fundamentally different. Commenting on this observation several years ago in *The Journal of Accountancy*, Thomas York noted that "too often it appears that the balance-sheet and the income statement are dealt with as if they were two actually independent statements, each with its own peculiar function to perform."19

A fresh look at both financial statements is essential because of two basic factors. The first of these is in the area of income determination. The implementation of the concept of matching expired costs and revenue has been cited as a major contribution of an improved income determination methodology. This development has been centered around the problems of cost and revenue recognition and timing but with some disregard for the presumably exclusive balance sheet problems.

Some areas of the balance sheet have continued to be valued with objectives other than proper matching in view. As trite as it may sound, perhaps it needs repeating that balance sheet values directly affect the income computation and vice versa. The overall perspective should be kept in mind, thus improvements in balance sheet value determination lead to and are consistent with improvements in income determination.

18 The following from *Accountants' Handbook*, op. cit., Chapter 12, p. 23, is typical of the attitude in many areas: "Adoption of the income criterion as the principal basis for selecting a method of inventory pricing has had certain undesirable effects upon the statement of financial position. Where necessary in order that income be adequately reflected, accounting is forced to condone the display of inventories upon the balance sheet at figures unrelated to their current replacement costs. Thus the utility of the balance sheet has decreased in order that the income statement be made more 'meaningful'."
The second reason why both statements must be taken in proper perspective was mentioned above by Patern. An improved income computation methodology will achieve ultimate usefulness when it is related to the underlying resources essential for its production. The rate of return on the resources employed becomes the most objective measure of progress available. This was advanced by I. W. Keller as follows: "the best common measure thus far for profit measurement and appraisal is the ratio of profits to assets - the return on capital employed."\(^{20}\)

The problems of determination and valuation of the resources which become a comparison basis deserve prime consideration if not income is to achieve maximum usefulness. The balance sheet is not an end unto itself as was implied in the past, nor however, is the income statement an end unto itself.

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\(^{19}\) Thomas York, *op. cit.*, p. 43.

CHAPTER V

A THEORY OF THE BALANCE SHEET

The present is a reflection of the past. This statement is true in financial reporting as it is in many other areas. The analysis of traditions, customs, and influences in previous chapters has been aimed to throw light upon the present and perhaps to assist in guiding future developments.

This chapter is subdivided into two major parts for convenience of treatment. The first part is concerned with financial statements, especially the balance sheet, and the second includes an analysis of the concepts underlying financial statements.

FINANCIAL STATEMENTS

Financial statements, especially the balance sheet, have been subject to criticisms from many quarters in recent years. To the short-term creditor the balance sheet fails to reveal realizable value of all current resources. To the long-term creditor the balance sheet does not show the current value of the security behind the obligation. To the security analyst the statement does not reveal all of the resources and claims on a homogeneous basis. To the stockholder the balance sheet does not indicate the value of his investment nor the reasonableness of his return. To the tax collector the report does not represent the "tax basis" of all the assets. To the public agency regulating industry the balance sheet values are not always subject to objective verification. To the economist the balance sheet on the one hand does not represent
present values and on the other the valuation methods differ among firms thereby hindering comparisons and aggregations. These objections have caused many to ignore the balance sheet almost entirely when analyzing financial position and future activity. The underlying reasons for the inability of the report to meet with general approval are twofold: (1) the failure of reports prepared under traditional, and sometimes obsolete, assumptions to satisfy the needs of the ever-increasing groups using financial data; and (2) the lack of a solution to the problem of price level changes. A solution to the first of the above problems would be a step forward in solving the second. Changes and revisions have been adopted from time to time but these have always been added to the existing patchwork. Consequently, the present statements are not entirely consistent with the needs of any one particular group.

George O. May, discussing statement form and contents makes this pertinent observation:

The balance sheet classifications of today are too largely based on conditions and needs that either have ceased to exist or are no longer of major importance. However, established usage and acquired familiarity are considerations not lightly to be disregarded. The practical course is, perhaps, to present supplementary statements which, as their value becomes recognized, will gradually make the older forms of presentation superfluous.¹

Although the author made these remarks more than a decade ago, very little change in form of presentation and contents has occurred. The need today is even more acute than when May was writing in 1950 because of the greatly expanded uses made of accounting reports and the substantial increase in price levels which has occurred.

¹May, Financial Accounting, Pp. 242-43.
The All-Purpose Balance Sheet

In view of the varied criticisms which have been made of the all-purpose balance sheet, an examination may be in order to see whether or not the concept of a general or all-purpose balance sheet is still valid.

There are, of course, several types of statements currently being used to meet specialized purposes. Statements for Securities and Exchange Commission purposes must generally follow prescribed form and contents. Statements for income tax purposes frequently differ in several respects from regular published reports. Statements of realization and liquidation, statements of affairs, and consolidated statements, are further examples of specialized reports.

The all-purpose statement, however, is firmly embedded in accounting tradition. The independent accountant has no control over the use made of statements which he has audited and on which he has issued an opinion. The statements with his opinion attached are frequently used and relied upon by many different users. Many times the uses to be made of the statements are unknown to the accountant at the time of their preparation. Lenhart states, 2 "The danger in undertaking to furnish single-purpose financial statements lies in increasing confusion and misunderstanding, and in the possible misuse of such statements for unintended purposes." Under this influence, the accounting profession has maintained that general usefulness would be better served by one set of all-purpose reports. The following quotation from Montgomery's Auditing

also indicates the trend of thought on this subject:

The usefulness of all-purpose statements, however, is too well established to warrant the substitution of other means of presenting the financial information to which stockholders and other readers are regularly entitled.\(^3\)

The all-purpose statements which have evolved are open to a number of shortcomings, however, and they have not gone unchallenged. Edward B. Wilcox, for example, states that management, investors, and creditors are interested in information peculiar to their individual needs, and that no one set of statements will best serve these needs.\(^4\) Jerome B. Frank, then chairman of the Securities and Exchange Commission, has questioned the feasibility of an all-purpose balance sheet portraying a complex business enterprise and at the same time satisfying all demands made upon it by many different users.\(^5\) He suggests the possibility of using single-purpose statements or supplementing the all-purpose statement with special-purpose reports.

The general-purpose balance sheet which has prevailed in practice is not general in the sense that it serves the needs of all users ideally.


\(^4\)"The demand for various single-purpose financial statements intended for restricted use, instead of so-called all-purpose statements for general use, is being heard with increasing frequency. Chief among the special purposes for which these new kinds of statements may be intended are management control, investment and credit." Opinion of Edward B. Wilcox in "Single-Purpose Statements", op. cit., p. 187.

\(^5\)"It may very well be ... that the balance sheet which attempts on two pages, with some accompanying explanatory notes or tables, to describe a vast business enterprise, cannot at the same time meet all of the varied demands made upon modern accountancy. It is possible that our all-purpose balance sheet cannot faithfully serve all of its many masters — the divergent and sometimes conflicting interests of creditors, stockholders, management, tax collectors, the regulatory agencies." As reprinted in "Single-Purpose Statements," op. cit., p. 186.
well. Such an accomplishment is well nigh impossible. It is rather a product which has been influenced by the needs of the major users through the years. Since the balance sheet does not completely fulfill the needs of any particular group, it has been subjected to widespread criticism. Although it is assumed to have some value to short term creditors in the analysis of working capital position, it is frequently considered to be of little or no over-all usefulness to stockholders and a host of other users. This general dissatisfaction with the balance sheet has caused many, especially stockholders, to turn almost entirely to the income statement for financial information.

A More Useful Approach

The alternative to all-purpose reports which is usually implied, that is, substituting a number of special-purpose reports, faces almost insurmountable obstacles. The fear, expressed by Lenhart above, of causing confusion and misunderstanding, and the danger of the use (or misuse) of such statements for unintended purposes, are very real and deep-seated. The fear if it were born out, would do violence to the very purpose of accounting—utility. The confusion which might arise from the publication of several different so-called "net income" figures

6"Some authorities have given up hope of satisfying both financial and operating interests and have seriously suggested that different types of financial statements be prepared for different groups, i.e., one report for operating men, one for bankers, and one for income tax purposes." Gilman, Accounting Concepts of Profit, p. 360.

7The following is indicative of the stockholder's viewpoint: "In the rather hurried manner so typical of the commuting stockholder he scarcely glanced at the pages containing the balance sheet and the message to stockholders signed by the president, concentrating his attention on the study of the final figures in the income statement, the amount of the net profit for the year." Foulke, op. cit., p. 38.
for the same firm during a given period is unthinkable to the accountant as well as to the businessman.

A more useful approach may be to orient the financial reports to meet the needs of a principal group and make allowances for supplemental or auxiliary reports or schedules to meet the particular needs of others. This is not an argument for "several" reports, each tailored toward the needs of the recipient. Rather it is a plea for "a" balance sheet and profit and loss statement, each consistent with each other, and each directed to the primary goal of supplying data to investors. Supplementary reports or auxiliary schedules to meet the need for specialized information would use the primary statement as their point of departure.

Such an arrangement would free the statements from their present irreconcilable position. Attempts at improvement of income determination are hampered by simultaneous attempts to present to creditors information significant to the latter's need. It approaches an impossibility, for example, to pursue the matching of cost and revenue concept in balance sheet presentation and at the same time to determine balance sheet values under the influence of past (but still existing) tradition of presenting only tangible, realizable property on the financial position statement.

The balance sheet will better attain its goal of usefulness if it is directed to and meets the needs of the users most directly concerned—the investors (stockholders and long term creditors). Management, of course, is vitally concerned with information which appears on the balance sheet. Its interest, however, is largely consistent with that of the owners, since management is acting for owners in somewhat of an agency relationship. Financial information as it relates to operating
decisions affects management in its day to day functioning. In this area, many analyses and schedules are presently being utilized by management in discharging its internal function. Financial reporting which is distributed for outside consumption is regarded as management's accounting to interested parties—investors, creditors, public agencies, and others.

Directing financial information primarily to investors is predicated upon the concept that in a free enterprise economy the prime objective of all economic activity is the production of income and the increase of wealth—proprietorship. The borrowing of short-term funds, maintenance of employee relations, reporting to governmental bodies are all auxiliary activities which are consistent with the primary objective. Accounting reports should conform to the main purpose of the enterprise and should be directed to the parties most immediately concerned. This, of course, is not a new objective in accounting. Paton in one of his earlier books brought this idea into clear focus as follows:

In all these forms of business organization the interests of the private owners are uppermost. It is the private investors and their managers that control operations... Consequently, the influence of the private equities upon accounting principles and techniques is predominating. It is hardly possible to over emphasize the importance of this fact.8

While the importance of the interests of investors has long been recognized in accounting, the reports and statements have not completely reflected this viewpoint. The development of accounting and financial reporting has rather revealed that although the statements were presumably directed to investors they were supposed to satisfy the needs of

8Paton, Accounting Theory, p. 19.
all other possible users as well. As a result, for example, current assets were valued on a liquidation basis, fixed assets were valued at cost, many intangibles were excluded or grossly undervalued, some assets were carried according to their "basis" for tax purposes, and liabilities were shown at their face value on the all-purpose balance sheet. Subsequent efforts to improve income determination have been overly concerned with income as such and have not resulted in improving the balance sheet.

The balance sheet oriented toward the viewpoint of the investors is essential to a proper determination of income, and more vitally, to a proper evaluation of position and activity. The accounting method of income determination is a process of matching expired costs and revenue. This concept has been used with considerable success in recent years to improve the reported figure of periodic net income. Matching costs and revenue has been considered to a large extent to be exclusively concerned with the income statement.\(^2\) The idea that the allocation of costs and revenue between successive accounting periods simultaneously determines the balance sheet values seems to have been tacitly ignored. The accounting process may be viewed as a stream of activity broken into arbitrary periods in which efforts, or costs, and accomplishments, or revenues, are matched to determine progress.\(^10\) The very process of recognizing an item as a cost applicable to a given period precludes it from appearing on the balance sheet. A cost or the portion of a cost which is not

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properly chargeable to a given period is ipso facto relegated to the balance sheet.

The matching process if applied consistently in all areas of accounting holds the key to the presentation of a congruous set of reports. If the balance sheet is directed toward the investors a closer correlation between costs applicable to current operations and costs which have significance for future periods becomes feasible. In 1940 Paton had this to say on the relationship between costs and assets:

Emphasis on the income statement as a flow of activity is tending to modify--and in a desirable direction--the interpretation of assets. In the past there has been a reluctance to recognize as an asset any charge which was not clearly assignable to specific elements of tangible property. The emphasis has been upon physical character and transferability rather than economic incidence in a progressing stream of operation. Deferred charges have been viewed as nothing more than a necessary evil at best, . . . But now there are signs that we are on the verge of a more discriminating view of the situation.11

While Paton’s timely observation was verified in some areas of asset and income determination the shortcomings of asset determination which are mentioned above remain to a large extent even today. A re-orientation of the focus of the balance sheet with one primary purpose in mind is necessary to accomplish an improved interpretation of assets. To attain this objective the balance sheet should be a statement showing basically monetary assets at present values, costs (all costs) having economic significance to the future income producing efforts of the enterprise, liabilities reflecting existing claims upon the assets at their present value, and residual equity revealing stockholder investment and subsequent growth. Revenue can then be related to the balance

sheet and recognized at the point of realization of a valid claim to cash or cash. This is essentially the position taken by most of the current accounting literature, i.e., revenue is considered to occur at the time of sale and delivery or at the time of the performance of the service. Expired costs can be related to the balance sheet as that part of total costs which have been expended on the revenue earning process during a given period. Costs which bear no relation to revenue but which are no longer significant to future revenue efforts would be charged against revenue also. The matching of these two forces, revenue and expired costs, will reveal a differential—net income or loss—which will be related to and consistent with remaining values on the balance sheet.

It is essential to keep in mind that net income as determined in accounting is not an independent factor. It is instead, a resultant which follows from a series of judgments as to the timing and amount of realized revenue (in other words the timing and amount of valid assets which enter the pool of values) and the timing and amount of expired costs and losses (in other words, the assets leaving the firm).

Objectives of a Re-oriented Balance Sheet

The objectives of an improved report may be summarized as follows:

1. Orient all financial reports primarily towards supplying data to owners (stockholders).

2. Present the balance sheet as a valid basis for comparison with and evaluation of income.

3. Present all monetary items and costs having future significance to income producing efforts of the enterprise.

4. Present all claims against the enterprise which will require the expenditure of assets for their satisfaction. These should be recorded at their present value.
(5) Present the status of the stockholders' investment and the re-invested increments therein.

Assets

Assets may be divided into two main classes. One group is represented by cash and claims to cash. These monetary assets may be properly shown at face value, in case of cash, or at face less allowance for collection uncertainties and discounted to present value in case of claims to cash. This is essentially the view expressed by the Committee on Concepts and Standards of the American Accounting Association in its 1957 Revision of Accounting and Reporting Standards for Corporate Financial Statements.¹²

The non-monetary group of assets should include all significant costs applicable to future income producing activities. This approach would require that many of the traditional methods of asset determination be adjusted to achieve consistency therewith. For example, the long followed approach as to the determination of certain current assets, debt-paying ability, should be amended to become consistent with the underlying purpose of the financial statements. This new approach would require a critical examination of inventory determination and valuation. The basis of inventory cost would be broadened and valuation methods such as lower of cost or market and LIFO would be rejected, at least for stockholder-oriented reports. The composition of traditional prepaid expenses and deferred charges would in many cases require broadening.

Plant and equipment frequently include only the expenditures made for new components. Substantial subsequent expenditures for long-lived improvements should not be arbitrarily charged to the current period in the name of conservatism or merely because it is desirable for tax purposes.

The area of intangibles and long term deferments represents the most indefensible under present practices. Expenditures which do not result in tangible property have always been suspected by bankers, credit men, and others interested in conservatism. The fact that these outlays may represent extremely valuable rights and advantages for future income efforts has been ignored. Recent large scale expenditures in advertising programs, market analysis and research, product and procedure research and experiment have made this inconsistency more acute. Not only is the balance sheet impaired because of the omission of significant assets, but the income in the year of occurrence is grossly understated and consequently is subsequently overstated. Correlation of income with investment requires that these costs be carefully appraised and that their treatment on the statements be rationalized.

Liabilities

The liability classification should include all claims which will require the use of assets for their satisfaction. These claims will normally have a maturity or payment date at some determinable future date. Liabilities should be recognized and recorded initially upon incurrence and at the present value at the time of incurrence. This view is essential for the corresponding recognition of the proper amount of value received (asset) or loss incurred at the time that the liability is recognized. Subsequent increase in the recorded obligation represents
periodic cost chargeable to each respective period.

Liabilities should be clearly reported on the balance sheet and a single total conspicuously displayed. Appropriation of retained earnings for possible future contingencies of various kinds should not be reported as part of the present claims existing against the enterprise assets.

**Owners' Equity**

Stockholders' equity should present clearly that portion which represents contributed capital and that portion which represents accumulated earnings. This will serve as an indication of past activities. Information as to par value, stated value, dividend rate, number of shares, and the like, should be included parenthetically or as a footnote. When two classes of stock are outstanding the amount contributed by each should be shown separately. Preferred stock with a restricted claim on earnings should be clearly reported separate from common stock and accumulated earnings. Stock on which the corporation has an obligation or intent to retire is more closely related to a creditor claim than to ownership and may properly be shown as such.

Retained earnings which have been capitalized and legally become a part of contributed capital should be specified as such in the capital section, parenthetically or preferably by footnote. Capitalization of earnings, although it has legal significance, does not produce a significant change in overall equities.
ACCOUNTING CONCEPTS UNDERLYING FINANCIAL STATEMENTS

Nature of Concepts

Financial statements, as a finished product, are closely related to the underlying body of concepts and standards upon which they rest. These concepts as conceived of in this study consist of the basic assumptions or the foundations upon which accounting practices and procedures are built. It is of course recognized that these are not promulgated by any authoritative body, nor are they the result of legislative action. It is equally true that they do not represent fundamental truths or laws which have been discovered. The American Accounting Association Committee on Concepts and Standards characterizes them as "conventions derived from experience." They may be described as a body of not-too-clearly defined assumptions which enjoy fairly wide acceptance by accountants and the business world and which are considered essential to promote useful, reliable and objective presentation of financial information. The utilitarian nature of accounting provides the only ultimate yardstick by which all concepts and practices must be measured. These concepts are not completely rigid and may change over a period of time, or new ones may evolve. The emphasis upon various concepts may also experience change.

The framework of underlying concepts affords a basis upon which there have developed various practices and procedures. As these gain wide acceptance they become guides to action or the "accepted practices."

\[13\] Ibid., p. 537.
These are, according to Canaan G. Blough, the off-quoted "generally accepted accounting principles." He defines an accepted principle as "one which has substantial authoritative support." Since these are the result of general acceptance and not legislative or judicial action they must obtain authoritative support in the usages of business, the views of authors, the expression of technical committees, and the opinion of governmental bodies.

An analysis of those concepts which most often find expression by authorities and official committees will be made below. An attempt will be made to indicate how each concept is consistent (inconsistent) with the general objectives established above.

**Entity Concept**

The entity concept is a general assumption which affords a basis for many of the other concepts. An accounting system is predicated upon the assumption that the recording of relationships and change in relationships of an economic unit or enterprise is its goal. The accepted object of each enterprise is producing a profit and increasing its wealth. The function of reporting should be consistent with the underlying objective of the enterprise, i.e., accounting statements should be directed toward those most directly concerned with profits.

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15 Ibid.

16 Ibid.
The double-entry equation, which is basic to accounting, is meaningless unless the basic assumption is accepted that there is a core or center of balancing relationships which is separate and distinct from any other unit.

This fundamental relationship is not necessarily concerned with the legal ramifications of incorporated or unincorporated units. The single proprietorship constitutes an accounting entity in a similar fashion that the corporation is an accounting entity. The relationships accounted for are separate from the owners. In the case of a corporate enterprise, which is also a legal entity, the entity concept is carried to its ultimate. Here for example, earnings are accumulated and do not "belong" to stockholders until a dividend is declared and paid. After the declaration of a dividend, a liability to stockholders is recorded (on the same basis as unsecured creditors) until payment.

The entity concept affords a basis for the consideration of all outlays of funds essential for, and instrumental in, producing future revenue as enterprise assets. Paton and Littleton adopt the following viewpoint in this area:

With the entity concept as a basis, there is no difficulty in accepting the proposition that all costs legitimately incurred by the enterprise are properly included, in the first instance, in the total of assets. Thus organization expenditures, costs of raising capital, and related charges are elements of enterprise assets and capital.17

The entity concept also affords a basis for consideration of revenues and expenses as changes in enterprise assets occurring within a given period as a result of enterprise activity. The net change (net

17Paton and Littleton, Corporate Accounting Standards, p. 9.
income or loss) measures the degree of success of the enterprise. Assets (or a portion thereof) cease to exist as such when they become consumed in this activity. Additional enterprise assets are created by the inflow of revenue activity. The rate of change (rate of net income to enterprise investment) provides the most objective measure of success or failure for comparative purposes.

Going Concern Concept

The going concern concept assumes that the enterprise will have unlimited existence. This is not an arbitrary disregard for the reality of frequent liquidations. The continuous existence is the predominant occurrence and hence the assumption follows the normal or typical condition.

The concept has an important bearing upon financial reports. It is thus assumed that assets will be used for the purpose acquired and need not be valued on a liquidation basis. The accumulation, transformation, and expiration of costs is assumed to occur in a continuous stream.

The periodic exhibition of the financial status and results are convenient devices which become useful only when it is realized that they are provisional extracts from a continuous process. The statements are not definite or exact with any degree of finality since the valuation of the majority of the items on the balance sheet is conditioned upon the assumption of continuity. Items of revenue and costs are also determined with this assumption in mind.

The going concern concept lends support to the inclusion as assets all outlays which have been incurred (as a result of the most propitious decision of management) if these outlays have significance to future
income producing efforts. These costs need not be charged to expense on the presumption that, if the enterprise were to terminate the costs would not have any realisation value, because this presumption is precluded by the going concern concept.

Cost Concept

In accounting, cost has been recognized as the most objective measure of acquired values. For this reason, as stated by Blough, 18 “property acquired for the purpose of being employed in the operation of a business, goods bought for consumption, for processing and for resale, and services received are measurable in terms of their money costs.” Acquisition cost is expressed as the amount of cash or cash-equivalent which is given up for the items or services. Hence the assumption is implied that the cost represents the true economic significance of the items or services at the time of acquisition. This flows from the assumption that transactions are effected by rational beings. Although it may occur that the purchase price in a given instance may not be the most opportune, due to lack of knowledge, unfavorable conditions, ignorance, or other causes, accounting must accept the only reasonable course, that is, that the actual agreement represents the most objective and useful yardstick.

The assumption that the recorded dollar cost (less amount assigned to operation over useful life) continues to represent the significant measure as long as the items or services have economic value is a corollary to the above concept. This assumption, still generally held, does not preclude adjustments for an unstable unit of measure, but maintains that cost remains the most objective and useful measure for over-all
utility. The American Institute of Certified Public Accountants in response to widespread clamor for the "official" sanction of adjustment for changes in the value of the dollar stated in Research Bulletin No. 43 that "it believes that accounting and financial reporting for general use will serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level." The American Institute of Certified Public Accountants while dealing with a practical problem of depreciation on replacement value, reveals its support, and reason therefore, for the underlying concept of a stable monetary unit. The following quotation is pertinent:

Should inflation proceed so far that original dollar costs lose their practical significance, it might be necessary to restate all assets in terms of the depreciated currency, as has been done in some countries. But it does not seem to the Committee that such action should be recommended now if financial statements are to have maximum usefulness to the greatest number of users.20

The American Accounting Association following a somewhat similar line of reasoning has given the following conclusion:

Conventional accounting practices, which include adherence to historical dollar costs in financial reporting, have evolved over a long period. At the present state of accounting development, the primary financial statements should continue to reflect historical dollar costs.21

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19 Accounting Research Bulletin No. 43, op. cit., p. 68.

20 Ibid., p. 69.

The American Institute of Certified Public Accountants, the special business income study group of the American Institute and the Rockefeller Foundation, a committee of the Canadian Institute of Chartered Accountants, a committee of the Institute of Chartered Accountants of England and Wales, and the Committee on Accounting Concepts and Standards of the American Accounting Association, have all encouraged the use of supplementary information to show the effects of changing prices, and all except the income study group have advocated continued adherence to cost in the basic accounts.

Adherence to cost in the basic accounts although not desirable for many purposes still remains the most objective and useful unit of measurement for reports to investors. Departures from cost for some purposes may be highly desirable and useful. Supplementary schedules or reports made to reflect price level changes will gain in usefulness if they are based upon basic statements which include all costs having future economic significance and when these costs are consistent throughout the whole statement.

Conservatism

It is not at all clear why the assumption of conservatism has gained such wide acceptance and has had so much influence, especially in the past. It has long been considered a virtue in accounting, to err, if one must, on the conservative side rather than to overstate. The conservatism assumption has no doubt been influenced by the atmosphere

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22E. Hough, "Accounting Principles and Their Application," op. cit., Chapter 17, p. 15.
of business to be cautious, especially in regards to credit policy, and the normal (usual) human tendency to want to be on the "safe side."

It has often been stated in the past as "anticipate no profits, and provide for all losses." As such it has had considerable influence upon many present day procedures. While the phrase is now considered somewhat crude and over-simplified, it is still, even if tacitly, regarded as an accounting virtue. Many current practices, such as, expensing advertising outlays regardless of period benefited, arbitrary write off of goodwill and other intangibles, lower of cost or market rule for inventory and temporary investments, recognizing income in nearly all cases only at point of completed sale, and the like, all have been influenced to a considerable extent by the underlying assumption of the desirability of conservatism.

Conservatism is no longer accepted as an accounting virtue per se, however. It is generally acknowledged that when it is applied without discretion in an accounting period, it may distort future statements, as well as produce misleading representation. It would be quite "conservative" to charge capital expenditures to operations, but current statements would be misleading and future income statements would as a result be highly unconservative. The application of conservatism for its own sake may be in direct conflict with the going concern approach of statement presentation. The rule of inventory valuation of the lower of cost or market which is expressly influenced by conservatism, is certainly not in complete harmony with other concepts such as cost, consistency, and going concern.
The assumption of conservatism while clearly not justifiable on strictly logical grounds in view of the overall objective of utility still influences some areas of accounting theory and practice. Finney and Miller, while giving it the status of an underlying concept, qualify it as follows: "conservatism, while desirable, is not a justification for the understatement of net worth or the mis-statement of net income." The consistency and objectivity of the balance sheet would be improved if traditional conservatism were tempered with the objective of showing all assets with future significance to investors.

Matching Costs and Revenue

The concept of matching costs and revenue has received more attention in recent years as a result of the increased emphasis placed upon income determination. This concept is stated as follows by Finney and Miller:

The determination of net income requires a proper matching of earned revenues and expired costs.

a. Revenues should not be regarded as earned until an increment has been realized, or until its realization is reasonably assured.

b. All costs expired during the period should be charged against the earned revenue for the period unless, for special reasons, a charge to Earned Surplus is justified.

The careful matching of efforts and accomplishments becomes very essential if periodic reports ("test readings") taken from this continuous stream will represent significant information. Costs may be

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24Ibid.
divided into two classes, i.e., those which may be associated with a product or service, and those which are considered a function of time. Overlapping of the two classes, as well as the tracing of costs from the original acquisition through various transformations and regroupings, especially over several periods, present considerable problems in practical application.

According to Paton and Littleton, "ideally, all costs incurred should be viewed as ultimately clinging to definite items of goods sold or service rendered." This concept the authors point out is sacrificed for a convenient substitute, i.e., a time-period is used as the unit for associating certain expenses with certain revenues. The time-period basis for associating expenses with revenues is the underlying justification for the "direct costing" method of allocating some of the traditional inventory costs as period costs.

The matching concept may be said to underlie all accounting processes of accruing and deferring. More specifically, these are methods of implementing the concept of effort and accomplishment over a series of pre-determined intervals. These are necessary as the actual outlay of expenditures for various products or services may precede or follow their utilization or expiration in the stream of economic activity. A proper matching of the costs which should be associated with realized revenue then becomes quite significant in determining not only income (excess of realized revenue over expired costs) but also in determining the costs which will be instrumental in producing future revenues.

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25 Paton and Littleton, Corporate Accounting Standards, p. 15.
The matching concept does not, of course, preclude the recognition of windfall gains (where no costs are involved) or losses (where costs expire without any related revenue). This broadening of the concept is justified by Paton and Littleton as follows:

Gains augment the asset total, whether they are derived from planned effort at a cost or from accidental occurrences at no cost; losses diminish the asset total, whether they result from . . . unpredictable occurrences wholly unassociated with efforts to produce a return.26

This concept is not only essential to the proper determination of income but it is equally vital in the proper determination of balance sheet values. The extension of this concept as a criterion for asset determination is a necessary step to achieve greater consistency between the two reports.

Consistency

Consistency is here included in the group of accounting concepts although many authors and writers would exclude it. It is highly essential to the reader of financial reports that procedures and practices have been consistently followed if he is to obtain reliable information. It has been stated that the consistent application of a method is more important than the original choice of the method.

Comparisons from year to year, which are essential to proper evaluation of a dynamic enterprise, become meaningless or even misleading if there have been changes in the procedures followed. Current practice of showing financial statements in comparative form for two or more periods as a means of enhancing the utility of the reports rests largely upon this concept.

26 Ibid., p. 18.
The consistency assumption is not, however, an attempt to prevent changes which would improve the presentation or which becomes desirable as circumstances change. Full disclosure of such changes and the effects upon the statements are necessary in such instances to a proper evaluation of the financial statements.
CHAPTER VI

CONTENTS AND VALUATION PROBLEMS

This chapter is an examination of a selected group of balance sheet items in relation to their contents and valuation. These are considered some of the major areas where presently accepted practice is inconsistent with the objectives established in the previous chapter. The items selected include contents and valuation of inventories, life insurance investment, accelerated depreciation, intangibles, research costs, distribution costs, allocation of income taxes, and long-term liabilities.

Greater utility of accounting data to the group principally concerned, through a logical extension of the matching concept, is the underlying basis used throughout this chapter. It is believed that a more realistic income figure will result, and that the balance sheet values will be consistent with the income determined and will serve as a more valid basis upon which to measure the effective rate of return.

No attempt is made to suggest detailed techniques to implement the procedures advanced. A demonstration of the underlying reasonableness of the procedures and a manifestation of the contribution made toward the achievement of the desired results, represent a worthy first step in the direction of greater consistency and utility of accounting information.

87.
Costs Applicable to Inventories

The American Institute of Certified Public Accountants, in Accounting Research Bulletin 43, states that, "... the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues."¹

The problem of what constitutes "costs applicable to goods" however, is one with many facets in theory and practice. There are three positions generally recognized on this issue. These have been characterized as: (1) full costing, (2) absorption (conventional) costing, and (3) direct costing.

Full costing finds more support in theory than in practice. In The Accountants' Handbook for example, it is stated that, "theoretically, all costs associated with the acquisition of the physical goods and with the process of converting such goods into a saleable product represent inventory costs."² The Institute states, "cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location."³

In application, however, many difficulties are encountered in assigning costs to inventory units especially when there is little tangible evidence of a relationship. As a result of this, arbitrary decisions are frequently made to costs which are traceable to product and

¹Accounting Research Bulletin 43, p. 28.
³Accounting Research Bulletin 43, p. 28.
those which are associated with the period.

A compromise has resulted by adopting the so-called conventional or absorption costing method, which is now used in the majority of cases. The cost of purchased merchandise, or raw materials in the case of a manufacturer, which are funneled through the inventory account include generally the invoice price plus transportation-in costs. Costs incurred in purchasing, receiving, storing, pricing, displaying, and the like, normally do not enter the inventory account. Logic does not support the view that these costs are less essential than the invoice price and transportation-in costs in the final production of sales revenue. Presumably, however, the insurmountable obstacle of assignment precludes their inclusion in inventory.

The application of costs to manufactured items presents even more difficult problems. The precise determination of costs applicable to the manufactured article in addition to the material and direct labor utilized becomes extremely delicate. Conventional practice in accounting has been to restrict these additional costs to factory overhead. Thus, administrative, managerial, and other costs not directly or wholly concerned with the factory operation are usually considered as period rather than production costs. There is a rather wide range of differences in application by individual firms.

The other extreme, direct costing, represents a rather recent development in accounting. The objective appears to be that of producing information which will assist managerial decisions and cost control. The goal is to distinguish between those costs which vary with the volume of production and those which remain fixed at all levels. Only the variable (direct) costs are assignable to inventory
and these consist basically of direct materials, direct labor, and variable manufacturing expenses. The margin of sales revenue over direct cost and variable selling expenses measures the contribution made to the fixed (indirect) costs. This method would thus exclude fixed manufacturing costs from inventory and consider these as purely period costs. The emphasis here is not on inventory valuation but on data which will throw light on the operational aspects of the firm and hence will enable management to control costs more effectively.

L. J. Benninger states, "the thesis that fixed costs have no relationship to product tends toward the ridiculous. It is an obvious economic fact that costs of plant and facilities are incurred to produce products from the sale of which income is anticipated."

The direct costing approach represents an attempt to alter basic concepts in accounting to meet a particular need of one group of statement users. The apparent distortion of the general concept of income and the inconsistency which it introduces in the financial position statement are condoned for the narrower goal of supplying particular data to management.

In spite of the many problems of practical implementation, the more desired course is toward a broader interpretation of inventoriable

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5Accountants' Handbook, Fourth Edition, op. cit., Chapter 6, page 60 states: ""... absorption costing is primarily directed at cost finding and the measurement of profits whereas direct costing is aimed at cost analysis."

6Benninger, op. cit., p. 283.
costs. Certainly there are extremes where cost assignment to product becomes meticulous and the resulting differences are not material. Some costs take place after point of sale and hence, association with the product becomes less essential. The proper determination of income, which is the "major objective" of inventory accounting, supports the view toward a broader interpretation of product costs.

Matching costs incurred in the production of items which remain on hand at the end of the period, against revenue produced by the units sold does violence to the matching concept. In many cases, where there is fluctuation in the inventory level, these costs may be a material factor.

All costs incurred which lend utility to the product should properly attach to the product and these costs should not be absorbed by operation until the product has been disposed of, or until there is evidence that the utility has expired. These standards are essentially in conformity with the objectives advanced in the previous chapter. The primary goal of accounting is the proper determination of income and the means for the evaluation of income. The incurrence of costs by a profit seeking, going concern represents a natural preliminary step in the production of revenue. For the merchandising concern, revenue is considered realized at the point of sale. A logical counterpart is to consider all costs intelligently incurred to accumulate to the point of revenue and to expire, leave the firm, in exchange for the revenue received at the point of sale. This, of course, would not preclude recording as period costs those expenditures which, although incurred

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7Accounting Research Bulletin No. 43, p. 28.
with the object of producing revenue, expire prior to the point of sale.

The point of revenue is the critical test of the efficiency of a firm in its costs-incurring activity, for it is the point at which net income (the excess of inflow of revenue over the outflow of cost) is measured. This concept is essentially in line with the thought expressed by the American Accounting Association Committee on Concepts and Standards. In the 1957 Revision of Accounting and Reporting Standards for Corporate Financial Statements the Committee states:

The realized net income of an enterprise measures its effectiveness as an operating unit and is the change in its net assets arising out of (a) the excess or deficiency of revenue compared with related expired cost and (b) other gains or losses to the enterprise from sales, exchanges, or other conversions of assets.®

The Committee defined expired costs as "those (costs) having no discernible benefit to future operations." These costs were subdivided by the Committee as expense, "the expired cost, directly or indirectly related to a given period, of the flow of goods or services into the market and of related operations," and loss, "expired cost not beneficial to the revenue producing activities of the enterprise."®

While recognizing the importance of the cost related to the "flow of goods or services into the market," the committee does not advocate a broadened concept of inventoriable costs. The Committee's view, however, would certainly appear to be in line with the underlying justification for the broader concept.

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®Ibid., p. 541.
The selling costs of a firm represent a major area which needs to be examined to determine if a broader interpretation can be used to advantage. Under present conventional costing procedure, this group of costs is considered chargeable to the period in which they were incurred. Selling or distribution costs may be subdivided into two types, "those required to bring inventory to point of sale and those necessary to execute the sale."\(^{10}\) Costs of the first type are just as essential to the final realization of revenue as the original outlay for the product. The "problem of traceability" is not necessarily a barrier.\(^{11}\) The difficulty of assignment of cost and the likelihood of some error are not accepted as barriers in assigning factory overhead to production nor in determining depreciation. An interesting observation on this issue is found in the Accountants' Handbook as follows:

> When cost association is not evidenced, such services must be charged to inventory on an assumed rational pattern of service flow, or they must be regarded as period expenses. The latter is merely an expedient treatment adopted to avoid the rationalizations of the former.\(^{12}\)

Costs of the second type, those necessary to execute the sale, such as advertising and sales commissions, are incurred at the point of sale and therefore, the problem of assignment to inventory may not exist. These costs constitute part of the broader expired costs group. Since the expenses in executing the sale do not apply to remaining units:


\(^{12}\) Ibid., Chapter 12, p.4.
on hand (unexecuted sale), the problem of inventory cost assignment does arise. There are, nevertheless, important problems which arise as to the determination of when these costs become associated with sale. For example, a large advertising outlay would require an allocation to expense over (usually) several accounting periods on the assumption that the sales of several periods would be affected. The problem of allocating such costs to expense is treated later in this chapter.

General and administrative costs, for example, salaries of top management, and cost of operating all the services departments such as accounting, personnel, legal, public relations, and security, are, under conventional methods, considered period costs. Except for the difficulty of tracing these costs to individual units of product, justification for this practice is nonexistent. When it is accepted that these costs were incurred for the purpose of bringing the inventory items to the point of sale (revenue), then it follows that the costs of those inventory items which have not been exchanged (sold) includes the total cost incurred for this purpose. To treat these as period costs arbitrarily is indeed "expedient treatment to avoid rationalizations." Difficulty of traceability of costs is perhaps more evident in the treatment of research and development costs. In this case a decision must be made as to whether these costs contribute utility to production. Where there is a service flow from these expenditures to the product, a decision must be made as to the procedure for assigning these costs to production in various periods. This area is given more extended coverage later in this chapter (see page 119), since it is considered to be major inconsistency in present-day financial statements.
A broader interpretation of inventory costs is not only essential for proper income determination but it is also necessary for an improved balance sheet presentation. The balance sheet has been cited earlier as serving as a basis with which to evaluate income and as an indication of future revenue producing activities. The inventory will not be a representative basis if a major portion of costs (which are just as essential as those included) are excluded. The computation of inventory turnover, for example, cannot be very reliable when both the numerator (cost of goods sold) and the denominator (average inventory) fail to include substantial costs. Surely the argument that a consistent reporting of deficient data is just as useful as long as it is consistent cannot be supported. The expression of the turnover with a rate of return (profit) per turnover is subject to the same shortcomings just mentioned.

As early as 1941, Paton voiced his opinion on the issues discussed above. He wrote as follows:

To me the traditional contrasting of 'cost of goods sold' on the one hand, and 'operating expenses' on the other, has been very unfortunate in that it has deterred the development of valid bases and procedures for the measurement of periodic income.\(^{13}\)

Paton, however, took full cognizance of some of the problems of practical application of costs to the product. He noted that "there will always be a fringe of charges which will be treated as expense in the period incurred regardless of underlying economic relationships."\(^{14}\)

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\(^{14}\) Ibid.
problems of application are not to be denied. They present challenges—not barriers. Accounting objectives of producing a properly determined income and a more useful basis for the evaluation of this income require that challenges be accepted and problems solved.

The advocacy of direct costing for financial reports represents an attempt to make a particular adaptation a general case. An analysis along the lines of direct costing is undoubtedly a useful managerial tool for cost evaluation and control. To use the direct costing method for financial statement purposes, however, is not consistent with the general concept of matching costs and revenue. Benninger notes that even under the conventional costing method, "... all benefits of direct costing can be obtained by a separation of fixed and variable costs. Under any well-organized accounting system, it is possible to prepare supplementary statements giving emphasis to variable costs and marginal income."15

Conventional costing itself has experienced a gradual broadening as methods of analyzing and tracing costs have become more efficient and feasible.16 Great strides have been made in cost accounting in recent years and the difficulty of allocating costs to inventory should not block future developments along those lines. A more complete implementation of the matching concept demands further broadening of inventoriable costs as a step forward toward greater utility.

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15 Benninger, op. cit., p. 282.
The Flow of Costs

A determination of costs which are properly included in inventory leads to the next problem, that is, the method of recording the flow of costs through the inventory.

The most realistic method of tracing the flow of costs is specific identification. This method, although ideal from the standpoint that it correlates the flow of costs with the movement of goods, is not widely used primarily because of difficulty of application. The three other concepts of inventory cost flow are average cost, first-in, first-out, and last-in, last-out. The average cost method assumes that the cost to be assigned to each unit leaving the inventory is composed of a representative cross section of all acquisition costs of the period. This method enjoys wide acceptance and use, in fact, the Accountants' Handbook states, "it (average cost) is probably the method most commonly used of all costing procedures."\(^{17}\) The advantages of this method, according to the Handbook, are that it is "simple to compute and free from the possibility of management manipulation," and "reasonably in keeping with the concept of money income."\(^{18}\)

The last-in, first-out method assumes that costs flow in the same general pattern as the physical commodities — "like a file of soldiers". This method results in depositing in cost of goods sold the earlier costs (older commodities are usually sold first) and retaining for inventory and balance sheet purposes the most current costs. The


\(^{18}\)Ibid.
constant upward movement of prices during the last two decades has resulted in severe criticism being directed at this method of costs flow. The basic conflict, however, is not with the method but with the results of its application under a given set of facts — rising prices.

Last-in, first-out represents a more recent method of tracing the flow of costs through the inventory. It assumes a "reverse chronological" order of costs flow and assigns more recent costs to cost of goods sold and earliest costs to inventory. This method has been characterized as the "by-pass" method. The original costs, or costs at the time of adoption, are first used to build up the inventory and thereafter costs do not enter the inventory pool but are passed instead directly to cost of goods sold. As a consequence, the inventory on the balance sheet contains the "older" costs. This method has gained many advocates and users during the last twenty years primarily because of the resulting effects upon income — and hence upon income taxes — which it produces in a period of rising prices.

At the present time there is still some controversy raging between LIFO and other cost methods, especially FIFO. The battle, however, has been largely won by LIFO if number of adoptions is an indication of victory.

This study will not include an exhaustive analysis of the pros and cons of LIFO, but a limited discussion will be made of this method from an over-all financial statement point of view. An evaluation of inventory cost flow centers primarily upon the adoption of a concept of income. The Accountants' Handbook makes this point explicit by saying, "... any discussion of the relative merits of assumed cost flows
separate from the concepts of income they are intended to implement is futile.\textsuperscript{19} H. J. McAnly states, "the argument pro and con about the soundness of LIFO are based upon different concepts of income."\textsuperscript{20}

The methodology of LIFO was adopted as a means to a desired end. In periods of rising prices many came to the support of some method that would reflect price increases in the cost of goods sold rather than in inventory. The primary objective of this group was to reduce reported profit and income taxes and, as a secondary motive, to allay dividend demands, labor demands, and consumer and governmental pressures for lower prices. "Unrealized profit" in inventory due to price increases, it is argued by the proponents of LIFO, cannot be used for the above stated objectives. A natural consequence was to define income so as to eliminate the "unrealized profit" in inventory by charging the currently incurred product costs to cost of goods sold. LIFO was advocated as a method which could accomplish this objective, and as soon as Congress and the courts sanctioned the method for tax purposes, the widespread adoption of LIFO began.

The arguments used to rationalize LIFO as well as those advanced to oppose it revolve basically around the concept of realized income. The conventional (FIFO and average cost) viewpoint has been that realization of income takes place at the time of sale and is measured by the excess of the revenue received over the cost of the units sold. The subsequent step which inevitably follows in a going concern is that the inventory must be maintained. This, however, is assumed to be an entirely new transaction representing the first step of a new cycle from cash.

\textsuperscript{19}Ibid., Chapter 12, p. 29.

to cash. The conventional concept may be illustrated as follows:

CASH --- COST FACTORS --- PRODUCT --- RECEIVABLES (OR CASH)

The viewpoint which has embraced LIFO is based upon the assumption that realization of income takes place not at time of sale but when the goods have been replaced. The amount of realized income is therefore, the excess of the sales price over the cost to replace the unit sold. This viewpoint holds that (under the assumption of permanence) the inventory must be maintained and that a sale automatically calls for a replacement. This view may be illustrated as follows:

COST FACTORS --- PRODUCT --- RECEIVABLES (OR CASH) ---COST FACTORS

The underlying rationalization of the LIFO approach resulted from the distasteful real-life experiences of applying FIFO under a condition of constantly increasing prices. The Accountants' Handbook makes a critical evaluation of the LIFO approach as follows:

Like many innovations, both LIFO and its predecessor --- base stock --- originated as ad hoc 'solutions' to the long-felt needs of certain managements. Both proved to be useful statistical devices for smoothing income by reducing the effects of price level changes on inventory valuation. Although, at the time of their introduction, neither possessed sound justification under what then were considered generally acceptable accounting principles, through the pressure of circumstances (rapid increases in tax rates and price levels) LIFO has forced its acceptance as one of a number of widely approved pricing procedures.23


It should be emphasized that the most potent argument for LIFO and the reason behind the increasing adoption of this method is admittedly the tax advantage. The motive for the individual firm is clear cut. LIFO produces a lower tax take by government during inflation. Adoption of LIFO by a firm under these circumstances is in line with the most compelling motive - the profit motive - of business.

The unfortunate situation, however, is that the firm which adopts LIFO for tax purposes must also use this method for financial statement purposes. This is one of the few instances where an accounting procedure is essentially "dictated" by governmental decree and this is deplored. The use of LIFO for tax purposes should not require its use in financial statement --- net income for tax purposes and net income for financial statement purposes are not always compatible and need not be.

The dilemma of rising prices should be examined closely before adopting a basic change in the realization concept. First it may be wise to inquire whether or not the problem of rising prices is an inherent phenomenon in our system. If it is, then it may call for a basic change in some accounting concepts. Although a long-range upward trend in prices may be demonstrated, recent developments are not completely conclusive for the individual firm.²

²Moonitz, for example, states, "Prices had risen sharply during World War I, had dropped abruptly a few years thereafter, had held reasonably stable during the twenties, had broken catastrophically in the Great Depression, were on the rise in uneven fashion after the spring of 1933, and were expected to drop again in the near future, as they did in fact in 1937 and 1938." "The Case Against LIFO," 683.
It is noteworthy, however, that in the current period (and it appears likely to continue for a number of years) the problem of rising prices is a very real one for the individual firm. The problem arises as to whether or not LIFO is the answer. In the area of inventory and cost of goods sold, LIFO leaves something to be desired from the standpoint of eliminating the effects of price level changes. The outstanding advantage of LIFO is presumably that it matches current cost of replacement with current revenue, thus cost of goods sold and sales are expressed in dollars of equal purchasing power. This is subject to the limitation that there is normally a time lag between acquisition and disposal. Noting this limitation, the Accountants' Handbook states, "if, however, large infrequent purchases are made, unit materials inventory decreases, turnover is low, and the production cycle long, there may be little relationship between the two." (revenue dollars and current replacement dollars)25

A major problem also arises whenever the quantity of the inventory decreases. This occurred in many instances during the Korean War when firms were unable to maintain their inventory levels because of shortages. It is quite likely that in the present so-called 1957-58 recession some firms have been following a cautious procedure by reducing inventories to a lower-than-normal level. This, of course, produces the very antithesis of the objectives of LIFO, that is, it results in charging to cost of sales the cost of the oldest and presumably the lowest priced units. Attempts to remedy this defect have resulted in the

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introduction of inventory "reserve" accounts. Under this procedure the cost of goods sold is charged for the estimated cost of replacing the base units sold. The difference between the cost of these units in the inventory and the estimated replacement price is recorded in the "reserve" account. When these units are actually replaced, the inventory is charged only for the difference between the price paid and the amount of the "reserve". This procedure, at best, is unrealistic and questionable.

In the area of inventory valuation for balance sheet purposes, even the advocates of LIFO admit that it produces abnormal results. There is no relationship between the units of product in the inventory and their assigned cost. In some cases, especially if a firm has been using LIFO since the early 1940's, the inventory on the balance sheet may be completely unrealistic. The justification usually given is that the balance sheet must be "sacrificed" so that the income statement can reflect a more "realistic" measure of income. Commenting on this "paradox", Gilman has noted that the effects of LIFO contradicts the thesis relating to the decreased value of the dollar. He indicates that it produces "inflated" costs in the income statement and at the same time "deflated" values on the balance sheet. 26

Moonitz, in building a case "against LIFO", questions the justification that LIFO is desirable because it produces a good income statement. He poses the query as to, "... how it is possible to have reasonably accurate statements of income accompanied by a series of admittedly

26 Comments made in Changing Concepts of Business Income, op. cit., p. 120.
Thus, Moonitz, as does Gilman above, highlights the inconsistency of LIFO when both financial statements are being considered.

LIFO does not accomplish its main objective very satisfactorily, that is, matching revenue with presently equivalent cost dollars, and it fails completely to present current dollars on the balance sheet. The underlying reason for the failure of LIFO is that it is not equipped to handle the real issue. The problem of changes in price levels is a real and very difficult one. It affects not only items sold but also remaining items, and every other asset and liability as well. In some instances the firm is affected adversely, and in others it is benefited. It is necessary to attack the whole problem to solve it. In other words, all items should be converted to a common dollar to eliminate the effects of the changing value of the dollar. In this manner the (inherent) consistent relationship between income and the invested resources and equities is retained.

It is maintained therefore, that cost flow methods such as FIFO and average cost which reflect realistically the flow of goods and costs and which are in agreement with the presently accepted realization assumption are superior for use in financial reports. The distortion caused by price level changes should be attacked from an overall point of view, a job which LIFO is not able to handle.

Pricing the Inventory - Cost or Market Valuation

In addition to determination of the flow of costs through the inventory there remains the problem of the valuation to be assigned to

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27Moonitz, "The Case Against LIFO," 689.
the units which constitute the inventory on the balance sheet. This section will attempt to analyze critically one of the traditional "sacred cows" in accounting, the valuation of inventory at the lower of cost or market.

The use and influence of cost or market represent one of the greatest paradoxes in accounting. It has received practically universal condemnation and yet persists as one of the most universally applied rules in accounting. William A. Paton, in one of his more typical observations, wrote, "no writer has ever been able to find a single definite point supporting the proposition that 'cost or market, whichever is lower' is a sound accounting rule." Gilman in Accounting Concepts of Profits and others have catalogued the opinions of proponents and opponents of this rule up to the time of their writings. No attempt is made here to reproduce these; however, observations are made on the changing concept which the rule presumably embodies.

The genealogy of the cost or market rule is not completely clear. Early records are sparse, and most contain little explanation as to

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28C. T. Devine states, "The rule of cost or market is widely used, particularly by trading concerns in spite of the most severe criticism. Charges that the method is 'illogical' that it has 'no basis in theory,' and that it 'distorts profits' have made it appear that the position is defenseless, and those who support it are doing so because of inertia and stubbornness." Inventory Valuation and Periodic Income, (New York: The Ronald Press Company, 1942), p. 74.


31See also Devine, op. cit., Pp. 75-78.

32A. C. Littleton, "A Genealogy of 'Cost or Market,'" Accounting Review, XVI (June, 1941), 162.
how valuations were determined. It appears reasonable to conjecture that the rule in its original applications was designed to produce something approaching current values, that is, market referred to realizable value. Gilman, for example, states, "Valuation of an inventory at realizable market price when lower than cost was an inheritance from the early trading ventures, strongly encouraged in later years by the doctrine of conservatism..." 33

Subsequent developments led to the practice of interpreting cost or market as the lower of cost or replacement price of the units. This rule was given official sanction in this country by A. L. Dickinson who, in 1904, stated that "the general rule for valuation of Stocks on hand, namely, 'cost or market, whichever is the lower', has been evolved and is adopted by the most conservative commercial institutions." 34 It was not until 1917, according to Devine, "that this system became predominant as a method of pricing stocks". 35 As defined and practiced for the next two decades the rule was wrapped in the "sacrosanct aureole of conservatism." 36

33Gilman, Accounting Concepts of Profit, p. 363.

34As quoted by Gilman, Ibid., p. 440.

35Devine, op. cit., p. 75.

36Phrase used by Devine, Ibid., p. 81.
Many potent and valid criticisms have been directed at the cost or market rule, nevertheless, it has withstood all attacks and remains firmly entrenched in practice. The basic shift in emphasis in accounting from the balance sheet to the income statement which took place during the late twenties and the thirties served to highlight the inconsistencies and "unconservatism" of the rule when consecutive periods were being analyzed. The use of the method admittedly distorted the income statement, however, the influence of conservatism on the current asset section of the balance sheet prevailed and the rule persisted and so did the inconsistency between the two statements.

George R. Husband writing in 1946, unable to resolve the dilemma of cost or market concludes that the current emphasis on the income statement makes it desirable, "either to revise the concept of historical accounting or to discard the practice of evaluating the inventory on the cost-or-market-whichever-is-lower basis."38

Attacks on the traditional view of cost or market continued to mount (in direct proportion to the increase emphasis on income determination). The American Institute of Certified Public Accountants through its Committee on Accounting Procedure, recognizing the "long existing need for a pronouncement which would produce a better understanding of the problems involved with inventory pricing", attempted to rationalize

37Gilman, Accounting Concepts of Profit, p. 429, states, "The rule has been persistently arraigned as an important cause of profit and loss distortion, a defect which has been admitted by many of those who favor it."

the rule by re-defining market. The Committee's expressed objective was "the sharpening of the concept of net income." In 1947 the Institute issued Accounting Research Bulletin No. 29, in which it stated the following:

Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, ... the difference should be recognized as a loss of the current period. This is generally accomplished by stating the goods at a lower level commonly designated as "market".

Market is restricted by the Institute in Bulletin 29 in that it cannot exceed net realizable value (estimated selling price less costs of completion and disposal) and it cannot be less than net realizable value reduced by an allowance for a normal profit. Thus, the Institute has attempted to arrive at a new rule of essentially the lower of cost or (defined) residual utility of the inventory items. Herrick, a member of the Committee, explains that the Committee took the position that cost was the proper basis for inventory valuation, except that whenever a portion of cost has lost its usefulness for profit making, the inventory should be valued below cost. He characterized the re-defined rule as the "lower of cost or residual useful cost."

Although the original concept of lower of cost or replacement price was abandoned, the Institute felt bound by tradition to maintain

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40 Accounting Research Bulletin No. 29.

41 Ibid.
the older (more conservative sounding) terminology. This is very un-
fortunate because many firms which have been using the "old" lower of
cost or market in the past will presumably continue using the method,
characterized by the Institute as having "no logical support," without
any information to the statement reader.

The change in the application of the lower of cost or market
rule is a commendable advance. The resulting charge to income and the
remaining balance sheet values will be much more consistent and rea-
listic than was the case under the older application. The Institute,
however, under the influence of traditions and the large number of
firms using this method, could not completely abandon market. Herrick,
for example writes, "... in considering the means of determining this
'residual useful cost' it (the Committee) concluded that replacement
market (within its newly determined boundaries) usually would be the
best and most convenient measure."\(^{42}\)

Under the guise of the traditional label, lower of cost or market
has presumably been refined to meet the objectives of the newer matching
concept of income determination. A basic inconsistency still remains,
however. A write down of the inventory because of a market drop (with-
in the new boundaries) may not result in a fall in sales revenue during
the subsequent period. The current period is thus being charged for a
loss which may not materialize. The reported income is understated and
the inventory on the balance sheet is understated. On this particular
point, Paton has written:

True, a sharp and sustained fall in costs will presumably
be followed by a decline in selling prices, but there are many
cases in which selling prices are more "sticky" than cost prices and in which a considerable fluctuation in costs may occur without being reflected in product prices. . . . To insist on applying 'cost or market' to such situations is nothing more than blind allegiance to a rule.\(^3\)

Cost which has future income significance should not be expensed unless there is clear cut evidence that the future sales revenue will be lower and the recovery of the cost plus disposal costs is impossible. A drop in replacement market need not be considered unless used as an indication of the behavior of the future sales price. In other words, a more useful and consistent concept would be the "lower of cost or net realizable value." Cost thus remains as the basic measure to be inventoried (this is in agreement with the Institute Accounting Research Bulletins Nos. 29 and 43) and this measure is altered only when evidence exists that a portion of this cost has expired in the current period and will not be recovered when the items are sold. In 1941, Paton advanced this same idea as follows: "If the change in the two price areas (selling price and market replacement price) has been such that current selling prices do not cover accumulated costs plus estimated costs to be incurred in completing and disposing of the inventory, there is reason for saying that an unrealized loss has accrued."\(^4\)

The position taken here is essentially that the best measure of the usefulness of the items in the inventory is their acquisition price (cost) except when current sales prices and economic conditions indicate that the cost (plus disposal expenses) will not be recovered in the following accounting period.


\(^4\)Ibid.
Investment in Life Insurance

Many partnerships and corporations now carry a substantial amount of life insurance on owners and key executives. The traditional method has been to recognize at least the amount of cash surrender value as an investment. The excess of net annual premiums over the increment in the cash surrender value is assumed to be the proper period charge. Upon collection of the policy, the excess of the policy over the accumulated cash surrender value is recorded as a gain.

It may be interesting to explore the underlying reasons for the significance placed upon the cash surrender value and to examine whether or not this significance should be continued. For example, the Third Edition of the Accountants' Handbook states,

Insurance policies can be viewed as having an investment aspect primarily in the case of life contracts. In connection with such a contract there is an accumulation of realizable resources, at least to the extent of the loan or cash surrender value. The minimum realizable amount which is recoverable at any given time is the cash surrender value of the policy. When life insurance became prominent the "debt-paying" concept of assets was the accepted mode and undoubtedly led to the now current practice.

In the current era of emphasis upon income determination it may be well to examine the rationalization of this problem. Two problems immediately suggest themselves, (1) what is the proper amount of annual expired cost, and (2) what is the nature of the "gain" which arises at the date of the insurance settlement. The object of securing the insurance according to Paton, is "to secure a measure of protection against

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a certain contingency.\textsuperscript{16} The fact that there is the accumulation of a cash surrender value, presumably justifies the recognition of an investment at least to the amount of the cash surrender value.

Costs become expired costs whenever they are consumed in the process of revenue producing, or they become losses when no longer effective in future revenue producing activities. The manner in which annual premium payments are consumed in revenue producing is not decisive, nor can these outlays be considered losses under the above definition. The premiums are expenditures made presumably to indemnify a future reduction in revenue which will take place at the death of the insured. Association of these expenditures with current revenue, while the executive is performing his duties, is not clear cut. Payments are made for the benefit of the company; therefore, they cannot be expected to improve the efficiency of the executive. These payments are made with a definite object in mind — recoupment of a substantial sum in the future upon the death of an executive to compensate for the loss of his services. It is true, of course, that in many cases, the insured may retire before the policy matures at death. In such instances, the employer will usually maintain the policy until maturity or will transfer the policy to the insured. In the latter case, the excess of the carrying value of the policy to the employer-company over the amount (if any) received from the insured would essentially represent compensation for past services.

\textsuperscript{16} Paton and Paton, \textit{Asset Accounting}, p. 178.
The collection of the proceeds of the policy at maturity gives rise to some form of gain in the nature of a windfall gain, "those asset-appearances which are obtained without observable effort and hence are not elements of operating revenues." Only the excess of the proceeds over the "cost" thereof would qualify, even for a windfall gain. The cost or effort, in this case, seems to require something more than the cash surrender value.

The going concern concept would seem to remove the necessity of recognizing only the cash surrender value as a measure of the investment. A more realistic measure should be found. Perhaps something similar to that suggested by Paton may be a step forward in this direction. He states:

Still another possible procedure is to find the amount of the annual installment required by the insurance company to accumulate a fund of $100,000 (or any other amount) during a term equal to the normal life expectancy of the individual whose life is being insured, and to treat a corresponding portion of each year's premium — plus the amount of an appropriate interest accrual on the preceding balance — as an investment.

The excess of the premiums over the annual increment in the investment could be considered as cost which is not "effective" to the contribution of future revenue and thus may be charged off to expense. A premature death would result in a windfall gain to the company.

**Accelerated Depreciation**

Accelerated or declining balance depreciation is treated briefly in this section because of the tremendous increase in the use of this

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47 Paton and Littleton, *Corporate Accounting Standards*, p. 17.

method in place of straight line depreciation which has taken place since 1954. The problems touched upon in this section are restricted to those which occur under the assumption that depreciation based on cost is being maintained.

Straight line depreciation has been the dominant method of recording the expiration of cost of long-term physical assets for many years prior to 1954. Undoubtedly the prevalence of its use was closely related to the fact that the income tax laws have sanctioned this method and rejected most other methods prior to the 1954 Code. For example, the National Association of Accountants Research Report on Current Practice in Accounting for Depreciation points out that, "depreciation methods employed in the accounts have generally been those elected and acceptable for income tax purposes."

Other than being acceptable for tax purposes and being easy to compute, straight line depreciation does not possess any significant merit. It has tacitly been assumed to reflect, at least fairly accurately, the expiration of cost and usefulness of fixed assets. Many have observed, however, that in numerous instances the usefulness of the assets and the allocation of cost through depreciation does not coincide. The rate of efficiency in many cases may drop rapidly after the first year or two. With the tremendous technological advances in recent years obsolescence has become a major problem. In spite of this, straight line has been considered acceptable in the majority of cases as a measure of cost expiration.

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With the advent of the 1954 Revenue Code a significant change has taken place in depreciation practices. A large number of firms began using accelerated depreciation methods. The study made by the National Association of Accountants Research Department clearly bears this out. The change of method was obviously motivated by the tax advantage which results under accelerated depreciation. The change, when made for tax purposes, represents management’s justifiable "desire to secure the immediate tax benefits from larger annual deduction for depreciation." The tax savings which accrue during the earlier years remain permanent as long as assets are replaced and the tax rates do not vary.

Apart from the problem of tax computation however, the acceptance of accelerated depreciation for tax purposes has led to the use of this method for general reporting also. The Research Report states, for example, "most of these companies (which elected accelerated depreciation methods for tax purposes) also employ declining charge depreciation methods in determining net income reported to stockholders."  

50 Prior to 1954, all but three of the fifty-five companies participating in this study used the straight line method almost exclusively, both for taxes and for accounting purposes. . . . The Revenue Code of 1954 led most of these companies to review their depreciation methods for income tax purposes. . . . forty of the fifty-five companies participating in this study have chosen to apply either the sum-of-the-years digits or the declining balance method to applicable assets for tax purposes." Ibid. Pp. 5-6.

51 Ibid.

52 Ibid., p. 21.
As it might be surmized, the Report indicates that the simplicity and economy of uniform methods for both tax and book purposes was a primary consideration. Other reasons included the following, "reduce the amount of stated income available for dividends", "provide a better measure of depreciation cost than does the straight line method", and (prevent) "understated depreciation cost and overstated income." 53 A few of the companies in this study admitted that declining balance depreciation was rejected for book purposes because it distorted reported earnings.

Although generalizations in this area are dangerous, it seems safe to assume that in the case of structural assets the declining rate under the tax laws is not very realistic as a measure of expired cost. For example, under the declining method a building with an estimated useful life of ten years would be depreciated 20 per cent during the first year of life. Under the sum-of-the-years digit method the depreciation would be approximately 18 per cent of the cost. Undoubtedly there are many cases, such as specialized machinery and equipment, where the above percentages are not unreasonable, or may even be too low because of obsolescence. Nevertheless, the wholesale adoption of declining balance depreciation primarily as a result of a governmental tax concession can hardly be commended as a desirable development. As indicated above, a procedure adopted and beneficial for tax purposes need not necessarily be carried into the financial reports if the procedure does not meet the standards of good reporting. In the areas of fixed asset depreciation where usefulness declines more rapidly during the early years

\[53\text{Ibid., Pp. 21-23.}\]
of use, these assets should be subjected to accelerated depreciation, otherwise, more realistic depreciation methods should be used.

Intangibles-Research Costs-Distribution Costs

In the area of intangibles, research costs and distribution costs the traditions of the past and modern concepts clash. The standards of asset determination in the past have encouraged immediate write offs of such costs in the period incurred or, whenever any part of these costs was capitalized, it has been amortized as rapidly as earnings have permitted. These costs did not meet the debt-paying-utility criterion nor the value-in-liquidation test. As the owner-viewpoint became more important and the matching of cost and revenue became a cardinal objective, the standards of the past have presented a barrier. In many areas traditions have prevailed; especially in those areas where the tax angle plays a major role, for example, in the case of research and distribution costs.

Intangibles

According to the Accountants' Handbook, intangibles "are ordinarily restricted to immaterial (nonphysical) noncurrent assets that are employed in the business." Accounting literature stresses the importance of showing these as assets if they contain income producing qualities — economic significance.

The American Institute of Certified Public Accountants subdivides intangibles into two groups, namely, those with limited lives and those without any indication of a limited life. Those intangibles having a

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55 Accounting Research Bulletins No. 43, p. 37.
limited life should be amortized over their useful lives whereas, intangibles with continued existence may properly remain as assets on the balance sheet indefinitely.

Historically, as pointed out above, intangible assets such as patents, copyrights, franchises, purchased goodwill, and the like, have been arbitrarily written down, especially during prosperous years, to nominal values such as $1. This was considered a virtuous achievement from the creditor's standpoint because it eliminated nonphysical assets from the balance sheet. Others also favored this practice because intangibles valued at $1 represented conservatism.

The increased emphasis upon income determination in recent years has served to indicate the inconsistency of the traditional viewpoint. Traditional conservatism serves to distort the reported income; in the year or years of arbitrary write-offs income is understated and in subsequent years income is overstated. The balance sheet after the write-off has limited significance because it does not contain all property having economic value to the firm. This situation becomes especially inconsistent when a comparison is made of assets and income, rate of return on investment, after the intangible costs have been written off. Assets (denominator) are understated and the income (numerator) is overstated.

In spite of the recent emphasis on matching of costs and revenue, and the almost unanimous advocacy of accounting authors and the support of the American Institute of Certified Public Accountants to the contrary, valuation of intangibles remains heavily biased toward the traditional viewpoint. The 1955 issue of Accounting Trends and Techniques,
makes the following observation:

Intangible assets were most frequently shown in the balance sheet at a nominal value (usually $1). The next most common method of valuation was an amortized value.56

A complete implementation of the matching concept is highly essential for a more effective determination of periodic income and simultaneously for a more effective determination of assets. Intangibles, when they contain future income producing ability, should be valued accordingly on the balance sheet and their cost should be allocated to income as they contribute utility to the operations. A plea of ignorance as to exactly how many periods will be benefited, or the amount chargeable to each period, should not be used as a justification for the gross distortion of the income statement and the balance sheet.

Research Costs

Research costs, as used in this section, include the costs incurred in the improving of existing products, creating of new products, and developing these to the point of sale. It encompasses, in general, the concept conveyed by the now standard term, research and development costs.

Without attempting to exhaust this new and vital area of activity, two statements are accepted as facts; viz., (1) a significant amount of funds is currently being directed toward product research and development, and (2) current practice, supported by much of the literature, generally follows the procedure of charging these outlays to expense in the year in

which they are incurred.

Since expenditures for research are material, it is important that they be properly accounted for in financial reports. The National Association of Cost Accountants Research Series No. 29, states the following:

When research becomes a major function, as it now is in many companies, . . . This requires an accounting plan which provides cost information for planning and control as well as proper reflection of research and development expenditures in overall company income and financial condition.57

The periodic expensing of these costs is usually justified by the following reasons: they are recurring in nature and hence essential just to stay abreast of competition; there is difficulty in relating the outlays to any specific revenue; and there is a high degree of uncertainty involved in determining when, and if any, benefit will accrue from this expenditure, as well as, the length of time to be benefited. 58

All of these factors have some validity, however, the same might be said with varying degrees of applicability of any expenditure which an enterprise might make in a competitive economy. There are no guarantees of success for any outlay and there exists no precise method of cost and revenue allocation in the majority of instances.

Very few firms would contend that the substantial funds being directed toward research and development are intended to benefit only the current year. The risk of failure notwithstanding, a firm which


58 Ibid., p. 1417.
pours $1,000,000 into a research project has its eyes as much (or
more) on the future benefits, as when it spends $3,000 for a new
truck. To charge the former to operations and capitalize the latter
seems a bit inconsistent. The fact that a firm "must" spend $1,000,
000 each year is not necessarily crucial to the point at issue, since
based on the same reasoning, it must also continuously replace its
tangible fixed assets.

Let us assume a hypothetical situation. Firm "A" embarks upon
a research program which will cost $1,000,000 a year for an indefinite
period and each year's expenditure will benefit the firm's product and/
or services for a five year period. If the firm follows the practice
now in vogue it will charge $1,000,000 each year to expense. The
balance sheet in this case will not contain any evidence of the research
program.

If this firm follows the practice of capitalizing these costs
and amortizing them over a five year period, by the fifth year and there-
after, the yearly charge to operations will be the same as above, $1,000,
000. The balance sheet however, will be materially different. It will
exhibit a substantial asset representing the unamortized portion of
the costs of previous years of $2,000,000. From the fifth year on,
the income statement would reflect a yearly charge of $1,000,000, how-
ever the reader of the financial statements would certainly have ad-
ditional significant information. The balance sheet would reveal the
research outlays. This is important because these outlays are frequent-
ly "buried" or scattered in the income statement without any separate
data given. But more essentially, the balance sheet would reveal a more
realistic and consistent picture, that is, that at any given time the
firm has considerable funds invested in the future in the form of research outlays. An effective evaluation of annual income with the related asset-base requires that these costs be included on the balance sheet.

The underlying reason for currently expensing research costs is more basic than those cited above. It goes back, rather, to the traditional viewpoint of asset determination. Costs which do not culminate in assets with physical properties (those you can stub your toe on) should generally be charged to operations, in other words, it is more desirable (conservative) to charge them to expense. The quotation which follows serves to illustrate this typical viewpoint as well as demonstrate the weakness therein, "the practice of expensing all research and development costs when incurred does not match costs and income from individual projects, but these errors tend to cancel out when the practice is applied consistently in a company where research is continuously underway."59 This quotation indicates a lack of understanding of the fundamental relationship of the financial statements and the "accounting period" convention. The logical extension of this idea would result in the elimination of all assets from the balance sheet except perhaps cash, and render the statements practically useless.

A far more candid reason for the current practice of expensing research and development is that given by a company controller in the NACA Research Series No. 29 as follows:

We have a continuing research program with no significant variation in expenditures from year to year. In fact, expenditures have been increasing somewhat steadily from year to year.

59 Ibid.
and will probably continue to increase. Under the circumstances, we feel it is more conservative to charge them off in the current year than to carry them forward to some future year when tax rates may be different. At least we know the after-tax impact of these costs in the years in which they are incurred.60

The two primary reasons appear prominently in the above quotation. Conservatism and tax considerations underlie the present reluctance to capitalize research and development costs. The reasons usually given are more in the nature of rationalizations of these underlying views.

Here as in other areas treated above, conservatism and the tax angle should not be used to justify procedures which are in contradiction to the matching concept applied to both the income statement and the balance sheet.

Distribution Costs

Distribution costs are broadly defined by Heckert and Wilson as "costs incident to all activities from the time the goods are produced, or from the time of purchase in a non-manufacturing concern, until they are in the hands of the consumer."61 As such, they constitute basically all costs incurred by a firm other than production costs or acquisition costs. These are classified by Heckert and Minor as buying, selling, transportation, storage, standardization and grading, financing, risk bearing, and collection, analysis, and interpretation of market information.62 These costs, for many years considered secondary to production

60 Ibid. (Emphasis supplied)


(factory) costs, have taken on greatly increased importance in recent years. The Accountants' Handbook states, "... in fact, in many concerns they (distribution costs) constitute the major cost element."63

In view of the importance and magnitude of these costs it is desirable to reappraise the traditional accounting concepts as to their treatment in the financial reports. Distribution costs have generally been assumed to affect only the period in which they were incurred. Great strides have been made recently in analyzing distribution costs, usually labeled distribution cost accounting. The objectives of distribution cost accounting, however, are designed to supply management with internal data to promote efficiency, control, and profitability. This analysis accepts the underlying assumption that distribution costs are period costs, ipso facto.

Many of the distribution costs are consumed in the process of producing revenue and have no significance beyond the period in which they were incurred. This fact does not warrant the assumption that all costs, other than production costs, have no usefulness beyond the period in which they were incurred. Commenting on this problem Paton wrote the following:

First, the accountant should not be unduly influenced by apparent physical connections --- 'what the eye can see and the hand follows'. ... When this aspect of the situation is more generally and clearly understood, we shall have little difficulty in seeing the reasonableness, under some circumstances, of postponing the application of a portion of advertising and other selling charges, and of office and administration costs, to the revenues of a period subsequent to that in which such costs were incurred.64

64Paton, "Recent and Prospective Developments in Accounting Theory," 10-11.
Some distribution costs, such as major advertising or promotional campaigns and marketing research and analysis, should not arbitrarily be charged to the period incurred. Under the criteria cited above in Chapter V, that an asset is an item having significance to the revenue producing activities of a subsequent period, it appears highly unreasonable to maintain that major outlays of the type mentioned above benefit, or are intended to benefit, only the current period. It seems hardly justifiable to defer a $5,000 or $500 insurance premium if it applies to some subsequent period, and in the same statement to consider as current expenses a $5,000,000 sales promotional or market research project. There is no argument advanced for deferral merely on the basis of dollars spent; however, an outlay of the latter magnitude will usually produce benefits for more than one period. It does violence to the logic and utility of accounting to accrue interest on notes systematically, and to defer short-term prepayments and short-term deferred credits, all of which are usually relatively small, and at the same time to charge a major expenditure intended for long-term major benefits to current expense. Certainly decisions based on reasonable judgment are not alien to accounting and to admit defeat because of difficulty does not appear commendable.

Serious attempt should be made to regard all costs incurred on an equal basis, and from this pool to allocate that portion which has expired during the current period to revenue and to retain the cost beneficial to future periods in the asset pool. Current practice now in use serves to detract from the usefulness of the income computation and raises doubt as to its real validity. A consistent extension of the matching
concept through the accrual and deferral of costs and revenue in all areas of financial statement presentation is imperative to greater usefulness in accounting.

**Allocation of Income Taxes**

The problem of allocation of income taxes between accounting periods basically arises from differences in the definition of net income before taxes for accounting purposes and net income for tax purposes. The related problem which exists when a firm has charges and credits to retained earnings which causes the accounting net income to differ from the taxable net income of the same year is not under consideration in this section.

Part of the problem revolves around the assumption made as to the nature of the income tax. General accounting practice holds that the income tax is a cost of doing business and is generally chargeable in the year paid or incurred. In particular cases, however, when there is a difference in the timing of an item of revenue or expense between accounting procedure and tax requirements, some have advanced that the under or over-payment of income taxes should be allocated over the periods affected. For example, when an item of income is includible in the tax return but deferred for accounting purposes, the tax actually paid on that item may be viewed as a "prepayment" of taxes (an asset) to be allocated to expense in future periods when the deferred income item is being allocated to accounting income. When an item of expense is deductible for tax purposes in the current year but deferred for accounting purposes, the reduction in the tax payment may be viewed as "taxes payable in the future" (a liability) to be allocated as a reduction in tax expense in the future when the deferred expense is allocated to expense.
This is the position taken by the American Institute of Certified Public Accountants in Accounting Research Bulletins 43 and this position was elaborated and rationalized by Maurice Moonitz in the Accounting Review.

Moonitz contends that the basis for the method he advocates is "let the tax follow the income". As such his argument appears to be in line with the objectives of accrual accounting and the matching concept.

A closer examination of this controversial area may be desirable. Several have taken a contrary position on the problem of income tax allocation. Thomas M. Hill, for example, concludes the following,

Disclosure in published financial reports of differences between the taxable net income for the period and the net income before taxes (accounting income) stated or implied in the financial statements is highly desirable. From the foregoing analysis it is concluded that such disclosure is not best accomplished by inter-period income tax allocation.

Hill argues that allocation requires too much subjective judgment, and the results are not readily comprehensible even to the well-informed reader, to be in conformity with the utilitarian objective of accounting. This author also questions the conceptual propriety of recognizing a "liability" for a tax underpayment and a "prepaid tax" for an overpayment.


The American Accounting Association's Committee on Concepts and Standards takes a similar view. In its 1957 Revision of Accounting and Reporting Standards for Corporate Financial Statements the Committee concludes that disclosure of tax prepayments or accruals on the balance sheet may cause confusion to the reader and it is considered undesirable.67

Aside from the practical problems of uncertainties and possible confusion, the nature of the income tax should perhaps be considered from another standpoint. A tax is an exaction by government levied to defray its expenses, pay its debts, and control economic activities. The federal income tax, as one of several possible types of taxation, is now one of the most important as to magnitude and effect. This tax is levied upon income as determined by Congress and the rates are set with many factors in mind, one of which is to provide government with an estimated amount of desired current revenue. This current tax revenue may be considered essential for the current operation of governmental services. Government makes no allocation of tax receipts. Current receipts generally flow out into the economy to pay for government services. Presumably if government desires to increase its tax revenue it can broaden the definition of income or increase the rates.

67"However, these items (prepayments or accruals) do not present the usual characteristics of assets or liabilities; the possible future offsets are often subject to unusual uncertainties; and treatment on an accrual basis is in many cases unduly complicated. Consequently, disclosure by accrual may be more confusing than enlightening and is therefore, undesirable." "Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision," op. cit., 541-2.
To the individual firm the income tax payments represent its cost of current government services which it must bear as a member of the economy. The exact computation of the annual tax bill is quite technical and involved. The method of computation is determined by government and the individual firm has no alternative except to comply. The income tax is levied upon income and measured by the amount of income which a firm earns according to the Internal Revenue Code. The "defined" income is the basis of the tax. The amount of the tax is determined by the amount of the defined income --- there is no assumption that the tax follows the (accounting) income, rather, it is measured by and follows the defined taxable income. The amount of tax, so determined, represents the firm's share of the cost of governmental services provided in the current year. There is no "benefit flow" to the firm in subsequent years as a result of paying a tax upon an item defined as taxable income, even though the firm chooses to defer the recognition of income for book purposes. The firm thus receives no future benefit from this tax and hence no asset is created. The fact that the tax, based upon the accounting-determined income will be "lower" in future years, does not warrant a different conclusion. The situation of accruing a "liability" through accounting treatment, because a firm expects to be liable for a tax in the future, is analogous to the above.

Each year should thus stand on its own, taxwise. The fact that comparability may be hampered in some years should not force "unnatural" procedures. Comparability is not the end of all accounting procedures. Full disclosure of all differences and their probable future effects should, of course, be provided the reader of the reports.
Long-Term Liability Valuation

Liability valuation presents problems very similar to asset valuation. This section is restricted to long-term liabilities, primarily because the weakness of current practice, while affecting all liabilities, in more material in the area of long-term debts.

Standards of asset reporting cited above call for the recognition, as assets of all items having future utility and require that they be measured on the basis of their present unabsorbed usefulness. Compatible with this, liabilities should be measured at their incurrence in an amount equal to the value (asset or services) received in exchange. If their maturity value is more or less than this value, then they should be increased by subsequent interest charges or reduced by offsetting interest charges.

Paton states that "the practice of recording face value in the main liability account is universally followed."68 This practice undoubtedly stems from the influence of showing all balance sheet items "conservatively" in the event that liquidation takes place. The influence of the face amount being the legal amount of debt also played a part in this tradition. This practice is not objectional, according to Paton, "provided the proper supplementary accounts are introduced and the facts are correctly reported in the statements."69 The factors which led to the showing of face value almost exclusively, also influenced the reporting of supplementary accounts. Since the face value was accepted as the

68 Paton and Paton, Corporation Accounts and Statements, p. 217.
69 Ibid.
true measure of liability, any difference between it and the price received a discount was considered a prepaid asset (quite unconservative) or a loss. An amount received in excess of face value was considered a deferred income or a gain.

A discount is more appropriately considered as a reduction in the carrying value of the obligation. A discount arises when the contract interest rate is lower than the current market rate. The price paid by the bondholder represents the present value of the fact amount of the obligation discounted at the current rate, plus the present value of the interest payments (an annuity) discounted at the current rate. As the obligation approaches maturity, its value approaches par (face) value. The original price of the obligation, if sold for less than par, plus the prorata amount of the discount which has accumulated, constitutes the effective measure of the issuing firm's liability during the life of the bond.

The two critical points in the life of an obligation, the point of incurrence and the point of liquidation, are thus properly reflected in terms of the corresponding assets entering or leaving the firm. During the life of the issue, the contract interest paid plus the portion of the discount being accumulated, represent the effective cost of the borrowing chargeable to operations. A premium would have the same, although converse, effect.

The same principles should be applied to other long-term obligations, that is, they should be reflected on the financial statements at their present discounted value. This is essential for a proper and consistent showing of the obligations on the balance sheet and the cost of carrying the obligations charged on the income statement.
CHAPTER VII

CLASSIFICATION AND FORM OF THE BALANCE SHEET

Classification in the broader sense may be conceived of as the whole of accounting. The main function performed by accounting is that of segregating, summarizing, classifying, presenting, and interpreting economic data. Classification of data for balance sheet presentation represents only a smaller segment of the accounting function of classification. The primary purpose of statement classification is the arrangement of data in logical order so that they can be absorbed more quickly and readily by the reader of the report.

Developments in Classification

Arrangement and classification for statement purposes must be tied to some basic objective or motive to take shape or form. Underlying objectives have varied and so have classification schemes. Evidence of early attempts at classification in accounting are sparse. Adam Smith undoubtedly influenced early efforts at classification by his division of property as "circulating" and "fixed" capital. It is quite interesting to note that Smith based his subdivision upon the method of producing revenue. He made a distinction as follows: circulating capital, "of which the characteristic is, that it affords a revenue only by circulating or changing masters," and fixed capital, "of

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which the characteristic is, that it affords a revenue or profit without circulating or changing masters.  

Early writings in accounting which touched upon the problems of classification reveal a vague distinction between circulating capital, current assets, and fixed capital, fixed assets. The distinction, however, was not always clear cut, nor were these two classes all-inclusive. Dickinson, as indicated above, presented the following order of arrangement: fixed assets, permanent investment, investment of reserves, working assets, current assets, and suspense debits. Esquerre suggested the following order: capital assets, working and trading assets, current assets, and deferred debit items. The classification followed in published balance sheets during the latter part of the 19th century and the early 1900's indicates a preference for the fixed-to-current arrangement.

There appears to have been a gradual shift around 1920 towards a current-to-fixed arrangement of assets. During the same time the concept of current assets was broadened to include stock in trade and supplies (labeled working assets above), as well as monetary assets. Roy A. Foulke, in his discussion of the evolution of the current asset and current liability classification, indicates that the adoption and use of these classifications in balance sheets took place over a period

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3Dickinson, op. cit., p. 38.

of many years. He observes that, "by 1915 the value of classifying items as current assets and current liabilities was well established in credit circles, both with banking institutions and mercantile enterprises."

The gradual shift in arrangement toward showing current assets first on the statement and broadening the contents of the current asset section was an attempt to reflect an underlying objective. Financial statements were assumed to be primarily directed to credit grantors and were expected to reflect solvency, hence a current-to-fixed or liquid-to-less-liquid arrangement gained popularity. Commenting on the influence of the creditor viewpoint on classification, Gilman writes the following:

Born of this financing viewpoint was the concept of current assets and current liabilities, the relation between which has long been regarded as a credit index. From this credit viewpoint has developed a custom of reporting assets in the order of their liquidity and in reporting liabilities in the order of their due dates.

Credit necessities are, therefore, largely responsible for the elements of present basic account classification, . . .

The current to noncurrent pattern appears to have been reasonably well suited to the objective sought—to show solvency and debt-paying ability. Primary emphasis was placed on revealing short-term solvency by matching current assets and current liabilities. The composition and valuation of current assets were defined to correspond to the underlying objectives;

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6Ibid., p. 186.
7Gilman, Accounting Concepts of Profit, p. 259.
and the arrangement, as a natural consequence, was made to emphasize this objective. 8

Solvency has reigned for many years as the generally controlling criterion of balance sheet arrangement. This is still true today, especially in the classification of current items. Commenting on present-day analysis problems, Foulke states that, "the classification of current assets is undoubtedly the most important classification in a balance sheet, as current assets largely determine the going solvency of a business concern." 9

Current accounting literature supports Foulke's contention as to the primary role of the current asset-current liability classification. 10 The current ratio (ratio of current assets to current liabilities) is the most widely used ratio in short-term credit analysis. Foulke considers this ratio, "particularly (valuable) as an indication of the ability of a concern to meet its current obligation." 11

Current assets

8 Roy B. Kester writes as follows: "... the first and basic purpose of the balance sheet is to show the solvency of the business and this becomes the controlling principle of the arrangement of the content of the balance sheet." Advanced Accounting, Fourth Edition, (New York: The Ronald Press Company, 1946), p. 45.

9 Foulke, op. cit., p. 71.

10 "The current ratio is a valuable measure of the ability of a business unit to meet its current obligations. Since it is a measure of liquidity, care must be taken to determine that the proper items have been included in the current asset and current liability categories." W. E. Karrenbrock and Harry Simons, Intermediate Accounting, Second Edition, (Dallas: South-Western Publishing Company, 1953), p. 826.


11 Foulke, op. cit., p. 188.
are still considered to be composed of cash, claims to cash, and items which will soon be consumed in the operations (that is, used to produce cash or receivables), largely as a result of the use of this section in determining short-term credit strength.

The American Institute of Certified Public Accountants, recognizing the importance of the current asset-current liability classification to creditors and others, stated that, "definitions of current assets have tended to be overly concerned with whether the assets may be immediately realizable." The Institute indicated that the proceeds of current operations, rather than cash in case of liquidation, was considered important and relied upon by creditors, and therefore, that the strict one-year rule for determining current assets and current liabilities should be abandoned.

The criteria for classification, according to the Institute, should be more closely related to the operating cycle of the business. The operating cycle refers to the flow from cash, to inventory cost, to receivables, and back to cash. The importance of the operating cycle appears to be not so much in determining contents, but rather in extending the time interval for current items. The effects of adopting the operating cycle is that in some instances inventories which will not be sold within twelve months, and receivables which will not be realized within a year can still be classified as current. The inclusion of (certain) prepaid expenses as current assets is given formal justification because, "If not paid in advance, they would require the

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use of current assets during the operating cycle." Thus, the Institute has largely endorsed the traditional composition of current assets, and has merely sanctioned the extension of the time interval in particular instances. This is a step forward, however, in that it recognizes the importance of operations and the going concern assumption.

Another viewpoint of current asset classification is that which emphasizes the function or character of the items. Dewing, for example, contends that the significance of current capital is not its ability to pay debts but rather the nature of its use in an enterprise. He points out that, because of the readiness with which current capital can be used to satisfy maturing debts, the liquidity factor has been emphasized as the most important one by accountants and creditors. "But this relative liquidity," Dewing argues, "is not the fundamental characteristic of current capital." The distinction to be made between fixed capital and current capital, "is a distinction which applies to the character of the capital itself. The one is permanently fixed in the

13Accounting Research Bulletins No. 12, p. 20. (Emphasis supplied).
15"We are using the term 'current capital' rather than 'current assets' because our emphasis is on the business as an organization created in order to carry out a specific purpose; and it is presumed that carrying out this purpose will result in a profit." Ibid., Footnote to Page 686.
16"This point of view is taken by those accountants who are particularly concerned with the attitude toward the accountants' balance sheet taken by credit grantors, who interpret economic values in terms of resources readily convertible into cash with which to meet maturing debts." Ibid., p. 687.
17Ibid.
business, while the other merely passes through from cash to buy raw materials to cash received from the sale of finished merchandise.¹⁸

Primary emphasis is laid on the character of the items in the current capital cycle rather than on the length of the cycle.

It is significant to note that Dewing recognizes that earning power is the basic factor in credit analysis. He writes as follows:

The banker has come to understand that the basis of credit is the presumption that the earning power will continue; it is not based on the amount of current capital nor on its selling price, nor on the liquidity of any kind of capital simply as such.¹⁹

The Change in Emphasis

Accounting has altered its emphasis. Solvency and debt-paying ability are no longer the primary objectives of statement presentation. The over-all emphasis in accounting is now on income determination. Change, however, is not always an orderly procedure. The change of an underlying objective or standard causes displaced relationships. Change initiates a chain reaction — the immediate result is that formerly related factors are out-of-relation — then some of the formerly related factors begin to adjust to the change — others take much longer — some cannot adjust and thus sever their relationship with the changed factor.

The focal point in accounting has shifted to the proper determination of income. As indicated above in Chapter VI, many areas of balance sheet contents and valuation have not been "adjusted" to the new underlying emphasis and these introduce inconsistencies. Classification

¹⁸Ibid., p. 689.

¹⁹Ibid., p. 710.
and arrangement represent another area which has not received proper attention in the light of the new emphasis.

The change in focus from solvency to the determination of income demands that classification and arrangement should be examined to establish what alterations should be made to achieve greater conformity with the new accounting objective. The most significant factor in the exhibit of solvency was liquidity, and therefore, assets were listed in that order and liabilities were listed according to due dates. Assets and liabilities were then subdivided between those that were current, a year or less, and those that were noncurrent. Under the assumption that solvency is no longer the primary objective of accounting it becomes necessary to re-examine the distinguishing qualities of assets.

Paton, recognizing that "a fair determination of income for successive accounting periods is the most important single purpose of the general accounting reports of a corporation," was one of the earliest authors to also recognize that this statement required a new appraisal of the essential character of assets and liabilities and their classification. Writing in 1940, he concluded the following:

There are two main kinds of assets. One class of assets consists of money resources, cash or near-cash in the form of receivables and marketable securities. The other main class consists of a pool of cost factors, costs incurred.

The reason given for this basic subdivision of assets by Paton is in the nature of "reconciling conflicting opinions regarding both periodic cost assignment and financial reporting."

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20 Paton, "Recent and Prospective Developments in Accounting Theory," p. 7.

21 Ibid.
Monetary assets represent funds which await commitment or utilization. The pool of cost factors represents that portion of past commitments which will be beneficial to future revenues. Paton admits, however, that there would always be some overlapping of the two groups.22

Under this approach, the significant cleavage is between monetary resources and those costs committed to future periods' operations. This approach has not received wide attention in the literature, nor is it used in practice. It has, however, received recent recognition (at least impliedly) by the American Accounting Association Committee on Concepts and Standards. In its 1957 Revision of Accounting and Reporting Standards for Corporate Financial Statements the Committee, discussing asset measurement, gives the following breakdown:

- Monetary assets — cash or claims to cash — should be expressed in terms of expected cash receipts adjusted for collection delay where significant....

Non-monetary assets — inventories, plant, long-term investments, and deferred items generally — are not as amenable to accurate money measurement. Such assets are typically stated at acquisition cost or some derivative thereof.23

This subdivision would seem to follow as a natural consequence from the Committee's definition of assets. Assets are defined as "economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service-potentials available for or beneficial to expected operations."24 Although the Committee gives no

22"I realize, of course, that there is some overlapping, as in all taxonomy. Cash on hand may be in effect committed and cost factors attaching to marketable inventory may be all but recouped. I also realize that there is some recovery of costs (in the case of land, for example) even in the event of forced liquidation." Ibid.


24Ibid., 538.
indication that it wishes to adopt this arrangement on the balance sheet, it does imply its preference for this grouping, at least as a basis for thought and analysis.

The earliest proponent of this form of analysis and arrangement was Stephen Gilman in his Accounting Concepts of Profit published in 1939. It appears as a logical outflow of his emphasis upon income determination. Gilman writes as follows:

A most helpful accounting concept, particularly in relation to profit determination, is the one which considers non-cash assets as being equivalent to deferred charges.25

He made a distinction between deferred charges to cash, such as accounts receivable, notes receivables, and investments; and deferred charges to income, such as inventories, plant and equipment, intangibles, and other assets. Once this distinction is accepted, Gilman suggests, "then one logical, even if theoretical, scheme of asset classification may replace the familiar 'current, non-current' basis."26 The groupings would be as follows: cash, deferred charges to cash, and deferred charges to future income.

The basic difference between this and the traditional scheme is in the treatment of inventories. Gilman notes, quite appropriately, that inventories, "are not of the same order as other current assets."27 There is a basic difference between inventories and receivables or cash.

25Gilman, Accounting Concepts of Profit, p. 45.

26Ibid., p. 300. It is interesting to note that Gilman included a footnote emphasizing that such an analysis was not suggested for practical use, but only as a concept essential to an understanding of accounting profit.

27Ibid., p. 301.
Inventories must be realized, disposed of, before they can benefit the firm or be used to pay debts.

The similarity between inventory and other assets such as fixed assets and intangibles is more notable than the similarity between inventories and cash if the matching concept is accepted. Gilman states, for example, "the difference between inventories, particularly merchandise inventories, and fixed assets are more obvious than significant." Both the inventories and fixed assets will be consumed in operations; the fact that the time interval is different does not change their basic resemblance as to income production.

The following quotation from Gilman appears quite appropriate to this section. Although the views he expresses have, up to the present, largely been ignored they remain potent nevertheless, and are more appropriate today because of the widespread acceptance of the importance of income determination. He concludes as follows:

They (inventories, fixed assets, intangible assets and prepaid expenses) are basically alike so far as their relationship to future income is concerned. . . . In fact, it is difficult to comprehend how a logical philosophy of accounting can evolve unless this concept (deferred charges theory) is adopted as a fundamental article of faith.\(^{29}\)

It might be injected by way of speculation, that one reason, out of many, why the procedure suggested above never gained acceptance is that the term "deferred charges" carries a stigma in accounting. To many it suggests something unpleasant — a questionable asset. Under the traditional viewpoint it was frequently used to designate those

\(^{28}\)Ibid., p. 302.

\(^{29}\)Ibid., p. 305.
assets which did not qualify for any of the regular classifications, and included such items as unamortized bond discount and outlays "capitalized" primarily to manipulate reported income. It is unfortunate that, when the term was used in a comprehensive manner as above, the old connotation followed the terminology.

Paton, writing in one of his most recent textbooks, takes cognizance of the monetary, non-monetary demarcation of assets. This idea, he suggests, may be expressed in the following form:

1. Money resources (available purchasing power):
   a. Cash on hand and in bank.
   b. "Cash in process" (ordinary receivables).
   c. Government bonds and other marketable securities (securities that can be converted into cash virtually at will).

2. Resources committed to operation:
   a. Current cost factors (material and supplies, work in process, finished goods, and current prepayments for services).
   b. Long-term cost factors (productive facilities such as plant, and long-term prepayments).

The breakdown given above is not exhaustive in that items such as intangibles and permanent investments are not mentioned. Intangibles would quite appropriately come under the classification of resources committed to operations, and would seem to fit properly under the heading designation of long-term cost factors. Permanent investments represent commitments made to secure long term benefits in the form of interest, dividends, capital gains, or business advantages. As such, they would very conveniently fall under long-term cost factors.

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30 Paton and Paton, Corporation Accounts and Statements, Pp. 399-400.
31 Ibid., p. 400.
A Suggested Approach

The subdivision of assets between monetary resources and committed resources is a proposal which has appeared as a result of viewing the balance sheet as a statement closely related to the income statement, rather than as a report aimed primarily at reflecting credit strength. This represents a forward step into an area which should be explored further. The American Institute Committee on Accounting Procedures, in broadening the concept of current assets, revealed a tendency away from the immediate realization concept and toward a going concern concept with emphasis on current operations. It went only far enough, however, to extend the time interval for classification purposes and to include certain prepaid assets in the current asset group.

The concept advanced by the functional classification approach appears superior to the traditional accounting classification of current assets. The functional approach recognizes the character of assets as being more fundamental than immediate debt paying ability. The character of the assets which is being stressed is the basic function of the various assets in the normal business operations. As described above by Dewing, there are two fundamental classes: "one is permanently fixed in the business, while the other merely passes through from cash . . . to cash . . . ." This view, while it has merit, also has some shortcomings. It is best applicable to a manufacturing concern, but applies to a lesser degree in the case of service concerns. It also "fits" more readily in a situation where the bulk of the assets are of a tangible nature.

Recent increases in the magnitude and importance of intangibles in the form of major distribution outlays (advertising campaigns, market research), research and development costs, and the like, have tended to
obscure the difference between some items of current capital and fixed
capital. The distinction between the "mill" and the "grist" becomes
blurred.

Another shortcoming of the functional concept, as described
above, is that the cycle or flow does not occur entirely within the
current capital group. In the process of converting raw material to
finished goods and selling the finished goods there is a transfer of
utility from all, or most, of the non-current capital as well. This non-
current capital, in a going concern, also requires continuous replace-
ment. Even in a retail firm or in a service concern the merchandise or
service sold includes a "partial sale" of the non-current items.

The flow from cash back to cash, with presumably more cash flowing
back because of profits, is a very fundamental concept. In the case
of a manufacturer, for example, cash is flowing into raw materials, labor
to make and sell the product, current manufacturing and distribution
expenses, supplies, equipment, buildings, intangible items, and many
other items. Cash is also flowing back from the continuous sale of the
finished product. Each dollar flowing in from the operation, repre-
sents a recovery of cost items, perhaps a majority of which are con-
sidered current, but also a portion of which represents numerous non-
current items, as well as an amount of profit. Some items, for example,
raw materials, affect only one cycle, whereas a piece of equipment may
contribute something to the flow for several years. There is even greater
disparity as to the length of time during which various items of fixed
equipment and buildings will benefit production. It is difficult to
make a rigid distinction between fixed and current capital, and this is
readily admitted by Dewing.\textsuperscript{32}

The difficulty of precisely segregating the permanently fixed capital from the current circulating capital makes it desirable to continue searching for more acceptable concepts. The proposal of distinguishing between monetary and non-monetary resources has a certain amount of validity when correlating the balance sheet with the income statement. Monetary resources, although they have been committed into the enterprise and at least a certain amount of which is essential for operations, do differ from non-monetary resources in that there is still an option available to the firm. They can be invested in income producing activities or commodities, or they can be used to pay debts or distribute to owners. All non-monetary resources represent funds which have been committed to operations, income efforts, and these must be realized in the going concern before they will again be available for disbursement.\textsuperscript{33} Monetary assets may be viewed as the part of the stream when the committed resources may again be diverted into operations or used for other purposes.

\begin{quote}
\textsuperscript{32}"In actual practice, in some specific cases, the distinction between producers' goods, fixed capital, and consumers' goods, current capital is difficult to draw. In our anxiety to make clear the economic, rather than the accounting distinction between fixed capital and current capital, we have implied a rigidity of classification which does not exist." Dewing, \textit{op. cit.}, p. 687.
\end{quote}

\begin{quote}
\textsuperscript{33}Foulke states, "Unlike accounts and notes receivables, merchandise does not represent definite claims to dollars. Merchandise must first pass through the sales process before it reaches the stage of representing an absolute monetary claim." \textit{op. cit.}, p. 82.
\end{quote}
To view all non-monetary resources as one homogeneous group may be somewhat awkward and laborious. There is, of course, a difference between inventory units and a brick factory building, or between a truck and the cost of a consumer-preference project. In many cases the time interval may be considered of some significance. All resources presumably contribute to income, but during widely fluctuating time periods which may range all the way from six months to sixty years.

It may be desirable to subdivide all resources into three general categories, viz., monetary resources, short-term cost factors, and long-term cost factors. The short-term or current cost factors would represent basically the inventory costs and short-term prepaid assets. The inventory costs could be viewed as the aggregation of past outlays in the income stream which are now nearing the point of realization. Long-term cost factors, physical and intangible, would represent those past outlays which are further removed from the point of realization.

Limited treatment has been given to liability classification in this section. Liability classification problems are usually closely related to those of asset classification. Since, under the approach illustrated above, the assets would still be marshalled, at least roughly, in a liquid-to-less-liquid fashion, it may be desirable to retain the present order of liability arrangement. There would no longer be any compelling motive to follow the one year rule as a dividing line for liabilities, however, a distinction between short-term and long-term claims may be advantageous for analysis. As such the short-term liabilities would be considered claims upon existing monetary resources and those monetary resources which are expected to be produced by the next accounting period's operation or the operating cycle if longer. Long-term Liabilities
would represent those claims outstanding against monetary assets to be produced by future periods' operations.

The first objection to this arrangement would undoubtedly arise from the argument that this arrangement would destroy the usefulness of the balance sheet for credit analysis. This may be countered first by pointing out that present statement contents make many traditional analyses highly questionable. Short-term credit analysis is now based largely on the current-asset-current liability relationship. The weakness, however, is that current assets are no longer primarily concerned with the reflection of liquidity. The working capital figure (excess of current assets over current liabilities) and the current ratio obtained from balance sheets have only limited significance in short-term credit analysis because of the contents of the current section. In the case of LIFO inventories, particularly, it seems hardly reasonable to compare current assets and current liabilities.

A change in the arrangement approach would require that many of the currently used ratios be altered or eliminated. This problem should be studied carefully since there exists a group of "standard ratios" which are useful for comparison purposes. This should not necessarily be a barrier, however, if it can be demonstrated that new and more useful ones can be developed. All of the basic data for statement analysis would, of course, still be available.

It is suggested that credit analysis may be benefited rather than hampered by the above arrangement. The credit grantor would be informed as to the current amount of monetary funds available, and would also be informed of the other resources which the firm has committed to operations, as well as, to that portion of the cost of those commitments.
which is still beneficial for future operations. This information, coupled with an analysis of recent income statements, would serve as an indication of additional monetary resources to be produced from the operations. From a going concern point of view, this is the most vital information which a creditor can obtain, for it is the monetary resources to be produced by profits which determines credit strength or the lack of it.

Thus, it appears that a logical extension of the matching concept in asset contents should encourage examination into the problems of balance sheet arrangement and classification. It may be that the current, non-current division, designed in the past to show solvency should be altered. It is desirable that some form of arrangement be advanced that is more compatible with the present emphasis in accounting in order that analysis of accounting data will be promoted and correlation between the two statements improved. Experimentation with arrangement, such as the division of assets between monetary resources and resources committed to operations, seems to offer a possible avenue of approach to the problem. The emphasis on income and income evaluation certainly demands that continued search be made for improvements in this and other areas.

**Form of the Balance Sheet**

The balance sheet may be considered a reflection of the underlying basic accounting equation. The specific form, consequently, has been influenced by the accepted view of the relationship of the factors comprising the equation.
Until recent years the two most common forms of presentation have been the account form and the traditional report form. The account form is essentially a horizontal arrangement with assets on the left and liabilities and proprietary interests on the right. The form may be illustrated in summary form as follows:

A. \[ \text{Assets} = \text{Liabilities} \]
   plus
   \[ \text{Proprietorship} \]

B. \[ \text{Assets} = \text{Equities (or Liabilities)} \]

Both forms of the equation above are similar in that whenever the caption equities or liabilities is used to describe the right hand side of the equation, a subdivision is made between creditors' interest and owners' interest. Form "A" above is supported by H. A. Finney and others, such as Roy B. Kester. The outstanding advocate of designating all rights in assets as equities is W. A. Paton. Using liabilities to designate the right hand side of the equation has had much support in practice, and has also received support from the American Institute's Terminology Bulletins No. 1.

The report form is a vertical arrangement with liabilities deducted from the assets, the remainder being equal to the proprietorship. This form may be illustrated in summary as follows:

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34 The word "traditional" is used to distinguish it from the newer version of the report form commonly referred to as the "financial position" form.

Assets
(less)
Liabilities
(equal)
Proprietorship (Net Worth)

Published reports from the early 1900's to the present continue to show that a large majority of balance sheets utilize the account form. Custom, convenience, and force of habit have been more influential than reasoned arguments. The study of financial statement practices by the American Institute of Certified Public Accountants for 1946 (Accounting Trends and Techniques) shows that 583 out of the 600 companies studied were using the customary account form as "assets equal liabilities plus stockholders' equity."

The Institute study, conducted annually since 1946, reveals an increasing number of companies using the "financial position" form. The financial position form is not synonymous with the report form but basically related thereto. The liabilities are usually deducted from the assets in successive stages, that is, current liabilities are deducted from current assets to show working capital, after which other assets are added and (usually) other liabilities are deducted in order to arrive at net assets. This latter amount is then exhibited as being equal to the total of the items in the owners' equity section. The data from this study show 16 (out of 600) companies using some version of the financial position form in 1946, while the number increased to 81 in 1955.

The study reveals two basic versions of financial position form. These may be illustrated in the following forms: 36

36 These forms have been adapted from C. A. Moyer, "Trends in Presentation of Financial Statements and Reports," Handbook of Modern Accounting Theory, op. cit., Pp. 446-7.
### A. Net Assets

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Less Current liabilities</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Net current assets</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Deferred charges</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Less long-term debt</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Net Assets</td>
<td>$ xxx</td>
</tr>
</tbody>
</table>

### Investment of Stockholders

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6% preferred stock</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Common stock</td>
<td>xxx</td>
</tr>
<tr>
<td>Earnings reinvested in the business</td>
<td>xxx</td>
</tr>
<tr>
<td>Total investment of stockholders</td>
<td>$ xxx</td>
</tr>
</tbody>
</table>

### B. Assets

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Less current liabilities</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Working capital</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Long-term investments</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Deferred charges</td>
<td>$ xxx</td>
</tr>
<tr>
<td>Total assets, after deduction</td>
<td>$ xxx</td>
</tr>
<tr>
<td>current liabilities</td>
<td></td>
</tr>
</tbody>
</table>

### Investors' Equities

<table>
<thead>
<tr>
<th>Component</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>$ xxx</td>
</tr>
<tr>
<td>6% preferred stock</td>
<td>xxx</td>
</tr>
<tr>
<td>Common stock</td>
<td>xxx</td>
</tr>
<tr>
<td>Retained income</td>
<td>$ xxx</td>
</tr>
</tbody>
</table>

Statistics from the American Institute of Certified Public Accountants study for 1955 show 73 companies using version "A" above and 8 using version "B". Of the remaining 519 companies, 514 were using the account form and 5 were using the report form in its traditional version.

For practical purposes, the so-called "new" financial position form may be regarded as an adaption of the report form. The Accountants' Handbook, for example, calls it a "type" of report form. 37 Most texts

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and literature of recent origin dealing with statement presentation, mention and illustrate this "new" development in form. Discussion, however, is usually limited to an official cognizance to the increased number of reports using the new form with no particular defense or criticisms, except that it may be recognized as an attempt by management and practitioners to improve statement presentation. In many published reports this type of presentation is used in conjunction with "simplified" terminology which is intended to illuminate the unfamiliar (nontechnical) reader. J. B. Inglis contends that the new form "has been devised to allay the amazement of readers who wondered just why the figures in a balance sheet balanced." He considers this development an improvement but suggests that it should be regarded as merely a beginning in the development of new forms.

Paton, in his latest text, recognizes the new "sequence" form as part of a general effort to "make financial statements more clear and intelligible to interested parties." He also, quite appropriately, views this as a return to the method of stating "the underlying equation of financial position as:

\[
\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}
\]

rather than as two equal measurements:

\[
\text{Assets} = \text{Equities}
\]

---

38 J. B. Inglis, "Recent Statement Show New Techniques in Annual Reporting are Being Widely Used," The Journal of Accountancy, XC (December, 1950), 475.


40 Ibid., p. 428.
The financial position form is usually justified in general terms as being a device to improve or increase the comprehensibility of the statement, usually to the not-too-familiar reader. When couched in such euphonistic terms it seems difficult to refute. Attempts at improvement in form of presentation, as in other areas, are laudable. The advantages to be gained by the financial position form, however, have not been convincingly demonstrated. It would seem that the presentation of a series of "net" amounts from successive deductions might encourage erroneous impressions — especially to the unfamiliar reader. This may well convey the idea that net current assets or working capital represents something (probably cash) "left-over" if the firm were to pay off all current liabilities.

This arrangement may also create the impression that current assets, presently shown, will be the source of payment of the specific current liabilities on the statement. This notion runs counter to the "going concern" concept which would infer that, immediately after the date of the balance sheet the composition of the current assets will change as well as that of the current liabilities. Some of the current assets will be used to pay operating expenses not appearing on the balance sheet, and some of the liabilities will be liquidated with funds not yet received.

Emphasis upon owners' equity is a very desirable characteristic of financial reporting. Such emphasis is also available through the conventional account form. The conventional form provides the reader with information as to total resources and their relationship to equities, creditors' and owners'. This arrangement conveys the underlying relationship of the balance sheet classes more forcefully and should be
maintained. It emphasizes, for example, liabilities, not as debts to be liquidated from existing assets, but rather as contributions to, or sources of assets. Liabilities "revolve", that is, they have constantly recurring maturity dates which must be met; however, liabilities are also constantly being incurred, at least in a going concern.

The emphasis upon income determination would seem to imply a trend towards the proprietary point of view and the report form of the balance sheet. This, however, should not be the case. An emphasis upon income, while it does highlight changes in proprietorship, does not alter the basic relationship between assets and equities therein. In fact, evaluation of income requires that total resources be considered. The computation of the rate of return requires the presentation of total resources and this analysis is useful in evaluating proposed changes in the various equities.
CHAPTER VIII

PRICE LEVEL CHANGES AND THE BALANCE SHEET

Fluctuations in the level of prices have been a constantly recurring phenomenon in our economy. These fluctuations have been described in various ways by various authors. As an example, Solomon Barkin writes the following:

While the last part of the nineteenth century (1865-1896) witnessed a long-time downward movement in prices, price variations were sharp within this period. Moreover this had been preceded and has been succeeded with alternating periods of rising prices (1790-1815; 1819-1869; 1896-1920) and declining prices (1815-1819; 1920-1939). Within each period the fluctuations are wide and the trends among the commodities are diverse.

It is also noticeable from an examination of price levels that there is evidence of a long term upward trend. R. C. Jones, states: "the computed (upward) trend for the fifty-eight years, 1896-1953, is approximately 2 per cent a year." E. B. Wilcox points out, "if we look to history as a guide . . . we may expect long range over-all trends to be upwards."

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1 Comments printed in Changing Concepts of Business Income, op. cit., p. 114.


The trend may very well continue to be upward for the foreseeable future. World political conditions, high costs of defense, big government with big debts, organized labor, and big business all have a tendency to contribute upward pressure to the level of prices.

The Accounting Concept of Income

The fluctuation of prices is a predictable occurrence although the direction and magnitude of the change is less certain. The atmosphere of business is, thus, one of constant change; in fact, this is a part of the nature of business transactions. In the constant cycle of exchanging goods and services in order to make a profit, the common medium of exchange, the dollar, has become the accepted standard in which to express the exchange. A comparison of the units of dollars (representing goods and services) given up with the units of dollars received in exchange has become the accepted mode in business of determining gain or loss. The knowledge of changes in the price levels has long been recognized and accepted as part of the risk involved in entering a business transaction. Solomon Barkin says, "part of almost every business transaction is a gain or loss resulting from good or bad timing with respect to price changes. It is true even in periods of rather narrow price fluctuations. The gains or losses are 'real' in the financial sense."1 The businessman cannot avoid the risks of price level changes; they are part and parcel of every business decision. Fluctuations in price levels may therefore be assumed to be a natural contingency of a free enterprise economy and they have become accepted a part

1 Comments in Changing Concepts of Business Income, op. cit., p. 114.
of business decisions and concepts.\(^5\)

Under the above assumption, the accounting concept of income has developed into what is now commonly referred to as "the historical cost concept" or the "monetary income concept." The two, although not the same, follow as a natural consequence. The historical cost concept indicates that cost, once recorded in the accounts, need not be adjusted to reflect changes in value or price levels. The monetary income concept, as distinguished from "real" or economic income, supports the comparison of an equal number of dollars for the computation of income.

A typical expression of the monetary income concept is given by the Committee on Concepts and Standards of the American Accounting Association as follows: "Under the present monetary postulate, the "costs" charged against revenue in measuring net income are, in general, dollar costs \(\rightarrow\) the number of dollars initially invested."\(^6\)

The matching of the "historical" dollars to the current revenue in the determination of business income has usually been characterized as resting on the assumption that "fluctuations in the value of money may be ignored,"\(^7\) or that accounting "assumes a stable measuring unit."\(^8\)

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\(^5\)It might be pointed that attempting to eliminate all effects of price level changes on financial statements is attempting to produce a condition which has never existed.

\(^6\)"Price Level Changes and Financial Statements," \textit{op. cit.}, 468.

\(^7\)\textit{Ibid.}

\(^8\)Paton and Littleton, \textit{Corporate Accounting Standards}, p. 23.
The monetary postulate too frequently conveys the idea that the dollar is accepted as inherently stable for accounting purpose and thus, whenever the dollar becomes unstable, the results of accounting data are invalidated (i.e., become useless). The following statement from the writings of Thorstein Veblen appears to support the above point of view. He stated that, "... among the securely known facts of psychology, as touches the conduct of business, is the ingrained persuasion that the money unit is stable, the value of the money unit being the base-line of business transactions." 9

The monetary postulate does not embody the idea that the dollar is stable --- experience proves that it is not and never has been for any period of time. Rather, this postulate maintains that fluctuations in the dollar are accepted as part of business risks and results, and no attempt is made to show the effects of such fluctuations (if indeed they can be shown) apart from the other forces affecting financial position changes. 10 The computation of income by comparing the "number" of dollars of costs and revenue has been generally accepted by the business world as a useful concept, not an irrefutable truth. 11 Our concepts of business customs, habits, laws, contracts and obligations, and regulations have been built upon it. 12


10 Comments by Solomon Barkin, Ibid., p. 114.

11 Ibid., p. 19.

It appears that the above assumption of monetary income and the monetary postulate are generally accepted without much question, except in periods of rather severe fluctuations in the level of prices. The American Accounting Association's Committee on Concepts and Standards for example, has stated that because of the impact of recent price level changes, "challenges have arisen as to the adequacy, for many purposes, of the conventional method of measuring net income."\(^\text{13}\) Ralph C. Jones indicated that the inflation during and after World War II has resulted in major discrepancies between the monetary and the real results of business operation.\(^\text{14}\) John E. Kane has contended that if fairly stable prices would have continued after the spring of 1950, the problem of price changes would have ceased to have much current interest.\(^\text{15}\) Thus, it is only when there are major or abrupt price changes that demands for adjustment are heard.

In view of the sharp increase in the level of prices which has occurred since 1940, it may be reasonable to question the validity of the monetary postulate for some purposes. The monetary postulate, as well as other assumptions in accounting, are not immutable laws; they must be constantly evaluated and reconsidered. In the final analysis

\(^{13}\) "Price Level Changes and Financial Statements," op. cit., p. 468.

\(^{14}\) Jones, op. cit., p. 1.

\(^{15}\) John F. Kane, "Structural Changes and General Changes in the Price Level in Relation to Financial Reporting," Accounting Review, XXVI (October, 1951), 496.
the ultimate criterion is usefulness. E. B. Wilcox brings this out forcefully as follows:

In considering any proposal in accounting, it is important to remember that accounting itself is artificial and rests, not on natural law, but on postulates and assumptions. Its aim and justification is usefulness. Proposals in this field cannot be rejected because they are 'wrong in principle'. It must be shown that they are not useful.16

The whole issue of price level changes therefore, centers about the question of the relative usefulness of conventional accounting data as opposed to data which includes price level adjustments. It is a matter of weighing the shortcomings of present practices with the changed relations and adjustments which would result from the introduction of price level changes in financial data. 17 Such a problem demands the greatest amount of judgment and foresight before a conclusion is reached; impulsive exclamations that present practices are "right" or "wrong" do not contribute greatly to this serious problem. Some, especially among accountants, have suggested that a real solution will be achieved whenever we learn to prove the underlying disease -- inflation. 18

16 Wilcox, "Fluctuating Price Levels in Relation to Accounts," op. cit., p. 266.

17 Wilcox, commenting on the results of price level adjustments, states, "The possibilities of confusion and dissatisfaction together with undeniable social and political consequences can be multiplied almost indefinitely, and while it cannot be claimed with certainty that these consequences will follow to a disastrous extent, the risk is great." Ibid., p. 268.

18 "The disease is inflation, itself, and its prevention would not only eliminate the accounting problems which result from it, but would also be of greater social usefulness than any conceivable adjustment of accounts." Ibid., p. 271.
An important study of the problems of changing price levels was made by the Study Group on Business Income. The Group made the assumption that the postulate that the monetary unit is reasonably stable should be rejected. It then attempted to determine changes that should be made in practice as a result of this assumption. The Group acknowledged however, that, "for the present, it may be well that the primary statements of income should continue to be made on bases now commonly accepted." The general conclusions made in the Study nevertheless, appear to favor the inclusion of price level adjustment within the financial reports, at least in certain cases. The Study Group stated the following:

But corporations whose ownership is widely distributed should be encouraged to furnish information that will facilitate the determination of income measured in units of approximately equal purchasing power...

The conclusions made by the Study Group is not shared by the majority of those who have officially considered the problem. As indicated above in Chapter V, all major groups who have studied the problems have recommended the use of supplementary schedules and statements to reflect price level changes, and all, expect the Study Group,

19 The Study Group was composed of accountants, lawyers, and economists drawn from business and professional pursuits. The project was sponsored by the American Institute of Accountants and the Rockefeller Foundation and their final report was entitled Changing Concepts of Business Income.


21 Ibid.
have advocated retaining cost in the basic accounts. The Committee on Concepts and Standards of the American Accounting Association, for example, maintained that because of long established usefulness of historical dollar costs a change to an alternative basis is inappropriate (i.e. less useful) at the present time.  

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The Use of Supplementary Statements

The basic issue, although much light has been shed upon it in recent years, still remains unsolved. The question still remains: Do price level changes which have occurred in the past two decades warrant discarding the historical dollar concept and incorporating price level changes in the financial records? Without cataloging all other arguments which have been advanced, it is assumed in this study that greater utility will accrue by adhering to the conventional assumptions in the general financial reports. This is predicated primarily upon the view that, although changes in the level of prices have been greater than which can be considered normal, present practices in financial reporting are in closer harmony with business customs, habits, relationships, and thinking than would be the case otherwise.

It is quite undesirable however, to assume that the problem of fluctuating price levels can be dismissed or completely ignored. Continuous study should be, and is being, maintained. The position taken by the 1951 Statement of the American Accounting Association Committee on Concepts and Standards is endorsed. Although cost should be retained in the primary records, useful data can be provided in the form of supplementary statements reflecting price level changes. The Committee

22"Price Level Changes and Financial Statements, " op. cit., p. 469."
there is substantial evidence that important informational benefits would be derived from a restatement of accounting data in terms of a monetary unit of uniform significance — should an acceptable means of adjustment and presentation be developed. These benefits would stem from the elimination — or segregation — of one hitherto unknown variable, the fluctuation in the unit of measure.23

The benefits to be derived from the inclusion of statements expressed in terms of current dollars, according to the Committee, would be as follows:

(1) The appraisal of managerial effectiveness in terms of the preservation of the current dollar equivalent of the capital invested in the business and not merely its initial dollar amount;

(2) The analysis of earning power in terms of the current economic backdrop;

(3) The determination and justification of sound wage policies; negotiations with labor unions;

(4) The determination by government of long-range policies with respect to 'control' of the economy through monetary policy, price regulation, limitation of profits, taxation, etc.;

(5) The creation of an informed public opinion with respect to profits, prices, wages, etc., and the effect of inflation (or deflation) upon financial relationships generally;

(6) The determination of managerial policies with respect to pricing, credit, dividends, expansion, and the like.24

Supplementary statements, it should be emphasized, are based upon the basic statements which are taken as a starting point. These statements are, not so much a departure from cost, as they are an adaptation or re-statement of cost. The Committee states, "it differs from the conventional original dollar cost concept only in that it recognizes changes in the

23 Ibid., p. 470.

24 Ibid., p. 471.
value of the dollar..." 25 The Committee goes on to point out that, "its application is independent of possible or probable future price changes, whether upward or downward, since only past changes in the value of the dollar are reflected in the adjusted figures." 26 It is thus implicit in the Committee's observations that it favors retaining the monetary postulate for the primary statements. It recognizes that although the upward fluctuations have been severe enough to challenge the utility of the postulate for some purposes, the basic statements are not repudiated, rather it becomes necessary, for greater utility in some areas, to segregate one variable factor.

Other Types of Adjustment

Considerable care should be taken to distinguish between adjusting statements (in this case supplementary) for price level changes and efforts at changing the basic nature of statements to reflect economic (real) income or replacement cost. These three are frequently intermingled and much confusion results.

Economic (real) income, as opposed to business income, is a very illusive term and one which defies a simple definition. Accordingly, no single definition of income, for the individual or the firm, has received wide support among economists. An idea frequently embodied in a definition of economic income is that of the relative position or well-being of a firm or individual between two points in time. This has been presented by J. R. Hicks as follows:

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25 Ibid., p. 470.

26 Ibid.
The purpose of income calculations in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves. Following out this idea, it would seem that we ought to define a man's income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning.27

The objections to attempts at implementing economic (real) income are numerous, two of which are assumed to be basic. The first of these is that the application of the concept to practical business transactions encounters almost impossible barriers. In other words, the practical problems of determining how "well off" an individual is at two different points --- cannot be objectively measured for it depends heavily upon subjective factors. Secondly, this concept is contrary to customary business thinking and functioning. For example, the accepted business concept of realization usually implies that income is not recognized until an arm's length transaction has occurred and an exchange consummated. The economic concept of income would also usually involve the recognition of various items as "costs" which are not cost in the practical business sense.

Efforts at introducing replacement costs into accounting records are more nearly compatible with traditional accounting and have received more support. The replacement cost concept, as discussed above in Chapter VI when treating LIFO inventories, lays emphasis upon charging current revenue with the cost of replacing the items being consumed. The objective is, in the case of rising prices, to achieve a more "realistic" income figure by charging current or future costs to current

27 As quoted by Study Group on Business Income, op. cit., p. 8.
revenue. This procedure will presumably result in the accumulation of funds sufficient for the replacement of the assets being consumed.

Different methods of implementation have been advanced. Some would achieve the above objective by using LIFO inventories and adjusting depreciation charges to reflect price level changes. Such depreciation charge would introduce some type of "reserve" on the balance sheet to take care of the increased replacement cost of the plant. Others would achieve the same general objective by using LIFO inventories and restating fixed assets to reflect increased price levels and/or replacement costs. Depreciation would then be based upon the adjusted assets. 28

The replacement cost concept has several shortcomings. First it represents a hybrid between income determination and fund accumulation for asset replacement. Increasing the depreciation charge does not, of itself, "produce" more funds to replace the fixed assets. Asset replacement although a necessary function, affects subsequent periods and not preceding periods. Closely related to this is the viewpoint that replacement, especially in the case of fixed assets, will usually not take place in kind, and that it is practically impossible to know the future cost of the replacement. 29 Adopting current or expected replacement cost as a measure of the charge to current revenue would represent a departure from historical cost and would thereby, according to the AAA

28 Some, for example, Wilcox and Greer in "The Case Against Price Level Adjustments in Income Determination," The Journal of Accountancy, XC (December, 1950), 496, make a distinction between these two methods as being separate approaches to the problem. The former is labeled the "purchasing power concept" and the latter the "replacement-fund theory."

29 Wilcox, "Fluctuating Price Levels in Relation to Accounts," op. cit., p. 263.
Committee on Concepts and Standards, "destroy to a considerable degree
the objectivity of accounting."\(^{30}\)

The major weakness of the replacement cost approach to price
level changes is that it is incomplete and introduces inconsistency
within the financial reports. If income determination methodology
under present concepts has lost its utility, then it would follow that
a comprehensive re-defining of income is necessitated. Price level
changes affect all assets, even idle cash, as well as all liabilities,
and hence a completely new concept of income and asset determination
would be required.

The adoption of some form of replacement costs into the account­
ing reports would also distort the relationship between the two basic
reports. The effects of the use of LIFO was discussed in some length
in Chapter VI above. The method, advocated by some, of charging currently-
adjusted depreciation to revenue could, by the accumulation of a replace­
ment "reserve", result in showing fixed assets at a completely unrealistic
or even at a negative net amount. Comparisons and ratio analyses between
the two statements and over the years would, of course, become useless.

Problems in the Implementation of Supplementary Statements

As indicated above, the position taken is that conventional con­
cepts of statement presentation should be maintained in the basic accounts
however, utility may be served by presenting supplementary data which
will isolate and highlight the effects of changes in the price level.

In presenting supplementary statements, one primary objective should be

\(^{30}\) "Price Level Changes and Financial Statements," op. cit., p. 471
to adjust all items on the financial statements which have been affected by changes in the level of prices. The AAA Committee has stated that this procedure, "is held to be essential to full disclosure." All the effects of a change in the level of prices should be identified for a proper evaluation of those effects. Some items will indicate that the firm has been adversely affected, such as the holding of fixed money claims or cash, others will indicate that the firm has benefited, such as the payment of old claims with current "deflated" dollars. Adjustments should be effected on both the balance sheet and the income statement to maintain their consistency and facilitate inter-statement comparisons and analyses. W. A. Paton has stated the following on this point:

The accounting structure is an integrated system and half-hearted tinkering with the income statement alone, with no systematic, well-grounded adjustment across the board, is not acceptable procedure. The objective of converting each item on the statements to a common dollar serves to highlight the necessity of starting with a meaningful and consistent base. Improvements in and greater consistency of the basic accounting statements thus become even more important. Results of converting the basic statements will be severely hampered if the contents of various asset items have been determined with conflicting objectives in mind. Practices such as the automatic charge off of research and development cost hamper the basic records and their analysis.

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31 Ibid., p. 472.

32 Paton and Paton, Asset Accounting, p. 351.
This shortcoming will be magnified when adjustments for price level changes are made.

Supplementary statements should not only be entirely consistent with the primary statements but the "difference", the price level variable, should be clearly explained and the two set of reports should be reconciled.

The precise means of implementing changes in statement presentation to reflect price level fluctuations are not subject to unanimous agreement. Most would agree that some form of price index is the most desirable method available. The Accountants' Handbook states, for example, "revaluation by appraisal was too expensive and time-consuming for many who sought this information, and they turned to revaluation by the use of index numbers as a relatively quick and inexpensive substitute."

Even the staunch advocates of price level changes however, will admit that a price index is not to be used blindly. It is a rough tool, at best, and its construction always involves subjective judgments on the part of the technicians who prepare it. To attempt to use it indiscriminately is unwise.

The problem of the particular index to use, also causes some consternation. The controversy seems to be between advocates of a general price index and a specific commodity price index. The use of a commodity price index is more feasible for the recognition of the replacement cost of various assets. Attempts to reflect current purchasing power dollars in the statements are more appropriately furthered

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by the use of a general index. The AAA Committee on Concepts and Standards has advocated the use of a general price index since it feels that "the effects of price fluctuations upon financial reports should be measured in terms of the over-all purchasing power of the dollar." It appears reasonable that when converting all items to a common basis a general index would be more meaningful. It should be recognized however, that in some instances the price of a particular unit may have changed conversely to the general price level. This fact serves to emphasize one of the shortcomings of index numbers and adjustments of price level changes.

In addition to the type of index, there is also the problem of the selection of a base period. There appears to be some advantage of using the current year as a base and converting all data to current year dollars. Most comparisons involve earlier years with the current and most users would normally be thinking in terms of the current year. Thus a conversion of all items to a common dollar existing at the end of the current year will facilitate more logical thought process and analysis. Paton states, "most people for most purposes are presumably thinking in terms of the current value of money."

The mechanics of implementing price level changes in financial statements by the use of indices have not been highly developed at the present time. In many areas there are no standard procedures, such as,

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35 Paton and Paton, Asset Accounting, p. 319.
what items to exclude, if any, and the means of converting income statement data which include aggregations of constantly changing dollars. Although the American Accounting Association, and others, have been on record for several years in favor of reflecting changes in supplementary statements through index numbers, such statements are practically non-existent. The reluctance to incorporate supplementary statements in published reports is likely based upon the feeling that readers would be confused thereby. Perhaps a lack of satisfaction with the methods thus far advanced for implementation of price level changes has also discouraged the use of supplementary statements. There are however, several research projects and studies in progress on the feasibility of, and mechanics for, price level changes in financial reports. 36

The most comprehensive study of the means of implementation of price level changes through index numbers was that which was carried on by R. C. Jones under the auspices of the American Accounting Association with grants from the Merrill Foundation for the Advancement of Financial Knowledge.37 The study, which included four companies, attempted to show the effects of inflation on these firms' financial reports over the period 1940 to 1952. The report highlighted the effects of price rises on rate of return, reported income, dividend rate, depreciation, and the like. The following general observation is considered pertinent here:


It must be emphasized here that the adjusted statements are not presented as substitutes for the historical statements and that differences between the two sets of statements do not mean that one is right and the other wrong. We know that the adjusted statements provide interesting information which cannot be found in conventional statements, but we do not yet know how useful that information may be.\(^{36}\)

It is interesting to note that Henry W. Sweeney proposed and illustrated detailed techniques to reflect changes in price levels as early as 1936.\(^{39}\) His proposals included the use of a general index applied to all items on the statements in order to measure changes in the "general purchasing power of the owners' investment in the enterprise."\(^{40}\) Although his proposals received considerable attention, they were not put into general use. Perhaps the most apparent explanation is that the problem of inflation was not the primary concern of the decade of the thirties.\(^{41}\) His work has undoubtedly stimulated and fostered many of the recent attempts at price level adjustments.

**Summary**

Substantial increases in the level of prices which have occurred since World War II have caused many to challenge the continued significance of conventional accounting reports. The challenge usually rests on the assumption that conventional accounting, assuming the dollar to be a stable unit of measure, is invalidated whenever the price level fluctuates. It should be emphasized that the monetary postulate does not incorporate an inherently stable price level, but rather it implies

\(^{36}\)Ibid., p. 2.


\(^{40}\)Ibid., p. 21.

\(^{41}\)Wilcox, "Fluctuating Price Levels in Relation to Accounts," \(\_\_\) cit., p. 261.
that fluctuations need not be separately accounted for. As such the postulate is based upon general utility and its conformity to business customs, practices, and procedures.

There is a certain degree of fluctuation at which point the monetary postulate should be abandoned. The current issue, which has attracted so much attention, is whether the price level has risen to a point where conventional statements are less useful than those which would incorporate a recognition of price changes. To date, the majority of accounting spokesmen and others have held that utility would be better served if conventional reports are maintained on a cost basis.

Many have advocated that usefulness for some particular functions may be achieved by including supplementary statements reflecting the effects of price changes in conjunction with the primary statements. These supplementary statements would represent restatements of the primary reports rather than departures therefrom.

The conversion of the primary statements by means of index numbers increases the need of having a meaningful and consistent basis to start from. Efforts at improving asset and income determination in the conventional statements are needed to improve the utility of the statements and these take on added significance when the statements are to be used as the basis of price index adjustments. The adjustment of the statements by the application of a price index magnifies any inconsistency in the basic reports.

Solutions frequently advanced, such as adjusting inventories through LIFO and depreciation through index numbers or appraisals, are not considered satisfactory. These are usually based on the assumptions that the income statement is the only important statement and that partial
adjustment of the income statement is sufficient. The implementation of this viewpoint results in a meaningless balance sheet, a partially adjusted income statement, and these in turn, destroy the inherent relationship between the two reports and nullify comparisons, ratios, and analyses.

Maximum utility of accounting data in the light of recent increases in the level of prices appears to better served, at least for the present, by continued improvement in the basic accounts maintained on a cost basis, and the presentation of supplementary reports to illustrate the effects of price changes. Continued study and research of the problem is, of course, desirable.
CHAPTER IX

SUMMARY AND CONCLUSIONS

Income determination is now generally recognized as the most important problem in financial accounting. This fundamental change in emphasis from the balance sheet to the income statement has been taking place over the past three decades.

This development in accounting correlates with, and may be considered readily traceable to, external forces. Accounting is, and should be, sensitive to its role of providing data useful to the various groups interested in the economic activity and well-being of business enterprises. The center of interest and responsibility in financial reporting shifted during the course of the first half of the current century from inside owners and creditors to investors, usually far-removed from an intimate knowledge and control of the enterprise. This development was taking place concurrently with the rise of large corporate concerns, drawing capital from a wide group of investors, with ownership shares traded on public exchanges, operated by a professional management, taxed by and under the benevolent auspices of an expanding government. Accounting has responded to the changing environment by focusing attention on a sharpening of the determination of income as the most significant data which it can provide to investors. The results of directing interest in this area have generally been salutary and continued efforts are desirable.
A seemingly natural outflow of the increased emphasis on income determination has been the tendency to overlook the balance sheet and to relegate it to a secondary position. The increased importance of income determination has presumably reduced the need for emphasis on the balance sheet. The resulting consequences have been that a lack of correlation has developed between the income statement and the balance sheet, as well as inconsistencies within each. Income determination efforts have been made upon an existing system, and as such, the effects have not been all-inclusive or simultaneous. There is always a struggle between adopting a new mode and relinquishing past accepted procedures.

Much progress has been made in accruing assets and liabilities and deferring unexpired expenses and unearned income through the implementation of the matching concepts. In accounting for inventories the expressed objective has been a proper determination of income; however, past traditions of showing solvency in the balance sheet continue to exert strong influences. Inventoriable costs and inventory valuation, such as the continued adherence to lower of cost or market, indicate a compromise of the matching concept in order to satisfy balance sheet traditions. The widespread adoption of LIFO since the early 1940's, primarily to alleviate the high income tax burden, has resulted in an unrealistic, if not useless, inventory for balance sheet purposes. Accelerated depreciation for tax and accounting purposes has gained wide popularity usually without regard for its appropriateness for the balance sheet. Partly as a result of obsolete standards of asset determination, and partly as a result of tax consideration major outlays for research and development costs, distribution costs, and other intangible
rights have been assumed to be period costs and consequently do not appear on the balance sheet.

The almost universal attention directed to income determination per se, and at the same time, the strong influences of past traditions have left the balance sheet inconsistent within itself and poorly related to the income statement. The objective of showing debt paying ability on the balance sheet which has prevailed in the past, has frequently run counter to the matching concept. There has been presumably a tendency to maintain debt paying ability standards in the current asset section because of the extensive use of this area in short-term credit and other analyses. There are, however, some inconsistencies even in this area. Cash and claims to cash are generally assumed to represent debt paying power, but inventories and prepaid assets are not generally valued with this objective in mind and are usually poor representatives of immediate debt paying ability. If a firm uses LIFO in a period of high or rising prices, the inventory may be well below its debt paying ability; however, if the trend in prices is downward, the inventory may be greatly in excess of debt paying ability. The introduction of prepaid assets is largely a result of the emphasis on income and this group has limited debt paying significance. Balance sheet assets, other than current assets, are no longer primarily concerned with debt paying ability.

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1 Firms which have adopted LIFO for tax purposes are required to use this method on financial statements. This has been an important factor contributing to inconsistent values in the current asset section.
The balance sheet, therefore, has evolved to a state of a dilemma. It is no longer designed primarily to provide information to reveal debt paying ability to creditors and inside owners; emphasis on income for investors has resulted in its being a patchwork of residuals derived from various assumptions and objectives. Conflicting forces, such as emphasis on income, influence of debt paying ability objective at least in the current asset area, tendency to report debts at their legal maturity value, demand to make some adjustments for price level changes, prevailing influence of conservatism, and others, all have contributed to the present state of inconsistency and limited usefulness of the balance sheet.

There exists an urgent need to analyze and re-appraise the balance sheet and its role in financial reporting in the light of the developments mentioned above. It is generally agreed that the balance sheet, as a component of financial reporting, has lagged in development. At this point a choice must be made between two alternatives. One is to go one step further and consider the income statement as the one important financial report and relegate the balance sheet to a series of schedules supplementing the income statement. This approach may be epitomized by the position taken by George O. May in some of his writings.2

2See "The Future of The Balance Sheet," The Journal of Accountancy, LXXXIV (August, 1947), 98-101, and Twenty-Five Years of Accounting Responsibility, 1911-1936, (New York: Price Waterhouse & Co., 1936), 121 pp. In the latter citation May stated that, "an annual report which contains a series of separate statements including: (1) a well arranged income and surplus account; (2) a classified statement of quick assets and liabilities; (3) summaries of capital obligations and capital assets; and (4) a lucid statement of resources which have become available during the year and the disposition thereof, will not gain greatly by the addition of a balance sheet . . . p. 72.
The other alternative is to recognize that the income statement and balance sheet, as well as supplementary schedules, are essential to convey information as to enterprise activity and position. Overall utility, completeness, and clarity demand that this alternative be accepted.

The income of a firm, in a free-enterprise, profit-seeking economy, is the most critical test of success or failure and is the force which directs the employment of resources in that economy. Accounting income is a differential resulting from a comparison of the inflow of resources, or revenue; and the outflow of resources or creation of liabilities, or expenses. An evaluation of revenue, expenses, and the resulting income which has occurred over a period of time also requires a knowledge of the changes in resources which they have occasioned, that is, the balance sheet serves as a test of the validity of the income.3

An important function of the balance sheet, which cannot be performed by any other report, is that of serving as a basis with which to compare income. The "rate" of income on total resources invested which a firm is currently earning is a more effective analysis tool than the absolute amount of income alone. R. C. Jones has stated, "the best single measure of the success of a business enterprise is the rate of return which it earns on the capital invested in it. Standing alone, the amount of net income has little significance."4

3 The use of a Statement of Application of Funds is also beneficial in this area.

In its own right, the balance sheet is essential to show, not only total resources, but total claims of creditors and owners and their relationship. To adopt a series of schedules in place of an integrated balance sheet would destroy the inherent relation between assets and equities therein and would convey the erroneous impression that particular equities will be satisfied from specific assets.

It is thus concluded that although emphasis on income determination has been desirable, there is a pressing need to place greater interest on the balance sheet and asset determination. Many areas of the balance sheet have been "gathering dust" and should be critically re-appraised and brought into focus. This development is essential, not only for an improved determination of income, but also to restore the consistency between the two reports and enhance their usefulness in financial reporting.

The first step in restoring the balance sheet as a proper component of financial reporting is to appraise clearly the objectives of financial reporting. In the present era of private, large-scale enterprises composing the dominant force in our economy, the spotlight has naturally turned to reporting to investors, and this is recognized as the prime, although not the exclusive, function of accounting data. This change, as pointed out above, has been recognized in the area of income reporting, a logical counterpart, and one long overdue is to rationalize the balance sheet to conform to this general objective. The balance sheet should become primarily a statement to evaluate past earnings, reflect present resources and the relationship of equities therein, as well as serve as an aid, along with the income statement, in the indication of future earnings. In this manner it can best meet
the needs of investors and others for financial data.

The aim is not to lessen the value of the balance sheet as a useful guide in credit analysis, managerial decisions, tax reporting, or regulatory reporting, but rather, to strengthen its role in these and other functions. The adoption of one primary goal will improve the reliability of the balance sheet. If creditors, for example, are aware that the basic statements are prepared primarily to inform the investors as to progress, position, and the indication of future progress of their investment, and that balance sheet contents and valuation are consistently determined with these objectives in mind, then their evaluation of credit strength will be enhanced. Supplementary data, which always has been essential for proper credit analysis, can provide creditors with the additional particular data which they consider necessary.

The objective that the balance sheet should be directed primarily to investors and be consistent with, and complement the income statement demands that asset, liability, and owners' equity classes be determined accordingly. Assets may be viewed broadly as monetary resources and those previous costs, which, as of the date of the balance sheet, have significance as to future income producing activities of the enterprise. This group would also include property received other than by exchanges, for example by gift. The emphasis is clearly on that portion of a previous outlay or gift which will benefit a subsequent period in the pursuit of its primary motive — income. Costs incurred which have no such future utility should be considered as expired costs, expenses or losses, on the income statement.

Liabilities represent previous inflows of resources which have occasioned the creation of a claim and which must be satisfied by a future
outflow of resources. In relation to income, liabilities are significant as to the amount of resources which they contribute (a measure of the resources which will be consumed in operation), as to the amount of resources consumed for their maintenance (interest costs), and, to a lesser degree, as to the ultimate resources needed for their satisfaction. At any given time, such claims should generally be recorded at the amount of resources presently needed for their satisfaction. This amount should be measured by the present value of the claims.

The owners' equity class represents the resources which have been committed to the enterprise by the owners and the increment in resources as a result of earnings retained in the enterprise. The growth factor is readily visible by an analysis of the increment in resources attributed to earnings. Financial reports should provide information so that the reader can pierce the legalistic veil which surrounds this section and obtain clearly discernible information as to the major sources of equity and as to the past behavior of each source.

The standards of asset and liability determination given above reveal a heavy emphasis on two of the concepts underlying financial statements. These are the matching of cost and revenue and the going concern concepts. The matching concept has generally been considered as the primary assumption in the determination of income. Accounting income is, in fact, defined as the resultant from a matching of expired revenue. The concept, however, encompasses the whole of accounting when

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the balance sheet and income statement are both oriented to a single major objective. Thus costs which have not been consumed in the production of revenue or expired without producing revenue during a given period represent "aggregates of service-potentials" which are expected to benefit a future period. Realized revenue results in the recognition of assets of commensurate amount for balance sheet purposes. These concepts of asset recognition, reporting, and expiration are contingent upon the acceptance of the assumption that the enterprise will continue to operate. If this assumption is rejected as not applicable, then the above theory of asset determination is nullified and a different theory must evolve.

Implementation of the above standards or objectives of asset and liability determination requires changes in several areas of the balance sheet. One of the most important areas of financial reporting is that of inventory determination, flow, and pricing or valuation. Inventories represent a major item on the balance sheet and probably the most significant item on the income statement. Although the American Institute of Certified Public Accountants has made great strides in improving the contents and valuation of inventories through an emphasis on income determination, much remains to be done. The components of inventory costs should be examined to determine if they are consistent with the above objectives. It appears that a much broadened interpretation of inventory costs is required. All costs incurred in the production of the inventory items and in carrying them up to the point of sale are part of the broader concept of inventory costs. This, of course, is not intended to include any costs which are not expected to benefit a future period's revenue activities. The flow of costs through
the inventory need not follow any one procedure exclusively; however, the costs should generally follow the movement of goods, as this is more congruous with the thought process as well as the physical facts. The LIFO cost flow method, although its objectives may be plausible, produces contradictory results on the financial statements and it is not recommended for reporting purposes. If it is deemed desirable to reflect changes in price levels, the procedure should be more comprehensive and encompass all items affected by price changes. The traditional method of inventory valuation for balance sheet purposes, lower of cost or market, is rejected as incompatible with the above standards of asset determination. Improvements in definition by the American Institute of Certified Public Accountants stopped short of a completely consistent definition. Lower of cost or market should be discarded in favor of a method whereby cost is the basic value, except, whenever evidence exist that cost will not be recovered in a subsequent period.

The current practice in the accounting treatment of insurance on the lives of key executives should be examined critically and in many cases altered. Charging as current expenses the excess of premium payments over the annual increment in cash surrender value during the life of a policy, and recognizing as gain the excess of the proceeds of the policy over the accumulated cash surrender value at the termination of the policy, may result in distortion of income and assets. Annual premiums represent basically an investment to indemnify a future loss of an executive’s service. It would appear more reasonable to capitalize that portion of the premium which is equivalent to the annual increase
in an annuity in the amount of the policy based upon the officer's life expectancy. The gain to be recognized at the time of death would be the excess of the proceeds over the accumulated amount of the investment.

The area of depreciation has always presented a vexing problem to accounting. Although not treated comprehensively in this study, the objective of depreciation is recognized as that of allocating the cost of long-life tangible property over its estimated useful life in a rational manner and at least roughly correlated to the flow of usefulness. As a result of this, exception is taken to the widespread adoption of accelerated depreciation, without regard to the reasonableness of the method as a measure of utility, primarily because it has been permitted for tax purposes. Income tax procedures should not hinder financial reporting on this or any other area.

Perhaps one of the major areas wherein the present balance sheet falls short of established objectives of financial reporting is in the accounting for outlays which do not result in tangible commodities. Traditional intangibles assets, such as organization costs, franchises, copyrights, leases, and purchased goodwill have long presented difficult problems for accounting thought and analysis. Practice has been, and still is, heavily influenced by conservatism and the solvency test. The American Institute of Certified Public Accounts and others have for many years, however, advocated that these be capitalized and amortized over their useful lives, and if they have indefinite longivity, they may remain as assets on the balance sheet. Research and development costs have become of major importance in many firms recently and practice in this area, supported by much of the literature, has generally regarded these
to be expenses in the period incurred. Whenever these are substantial
and they are expected to benefit future periods, which is frequently
the case, they should be capitalized and allocated to the periods
benefited as a step forward to determine periodic income more properly
and to improve balance sheet contents. Distribution costs have
evolved from a position of relative insignificance as to magnitude, to
a position of major importance. Standards of asset determination, or
the lack of it, in this area originated when production costs were of
over-whelming importance, and as a result, distribution costs have gen-
erally been considered period costs. Internal reporting for control and
managerial efficiency has recognized the significance of distribution
costs and this area is currently receiving considerable attention. It
is highly important that these costs be carefully examined for financial
statement purposes and that distribution expenditures which will benefit
future revenue producing activities be capitalized on the balance sheet.

The discrepancy between prescribed taxable income and accounting
income for a given period caused by the difference in the period of
recognition of various items of expenses and income have created some
knotty problems in the area of asset and liability determination. Con-
tary to the recommendation of the American Institute of Certified Public
Accountants and others, so-called tax prepayments and liability for
future taxes, occasioned because of the discrepancies noted above, should
generally not be recognized for statement purposes. Income taxes are
assumed to be chargeable in the year paid or incurred as defined by
government regulations. Differences in treatment for tax and accounting
purposes should, however, be clearly noted on the statement in explana-
tory note form.
Standard of liability determination adopted call for the recognition as a claim the amount of assets received by the firm at the inception of the claim. Accordingly, long-term bonds, as an example, should, when issued for less than par, be recorded at the issue price. Surely no asset (benefit to future) is created by a discount in this instance. The effective cost of the debt during the life of the bond issue should be the interest payments plus a prorata amount of the discount. Similarly other liabilities should be reported at their present discounted value, that is, the effective amount of the claim.

As a further step in the direction of enhancing the value of financial reports to investors and others it is desirable to examine critically statement arrangement and classification. Past practices, such as the importance given to current assets and working capital, may need alteration in the light of increased emphasis on correlation between the two financial statements.

In appraising assets in the light of the income objective, a particular analysis seems to appear. The total of the assets comprise the total of the resources which the enterprise has invested in the pursuit of producing a profit. Within this group, there appear two broad categories: those funds which have been appropriated to a specific objective in the revenue producing activities, and those funds which remain to be committed to operations or other purposes. The latter, group called monetary resources, is represented by cash and near cash items. These, or a certain portion, are essential to continued operation; however, they are liquid and may be removed from the firm or reassigned to revenue production. Funds appropriated or committed to operation within the
firms are one step removed from the liquid group. They have started their flow into the income stream. These funds are also one basic step away from realization and conversion back to the liquid resources. Some of these cost factors will be realized in a relatively short period, others will take much longer. For convenience they may be subdivided generally according to the time interval in the circular flow. Rigid classes should be avoided because there are no precise demarcation lines between assets which meet all purposes.

The above general analysis between monetary and other resources, as well as other arrangements should be continuously explored to enhance the over-all utility of financial data. Changes in arrangement and classification must always be made carefully and gradually, however, because of the many statement analysis practices and customs which have developed over the years.

The rise in the general level of prices which has occurred in the past two decades has been substantial, and this has caused many to question the validity of financial statements prepared under conventional procedures. Accounting, faced with a serious problem which cannot be ignored, has two basic alternatives. One is to accept a fundamental change in the constitution of income and asset valuation to reflect price level changes, and the other is to maintain the basic records according to conventional procedures with perhaps supplementary data to indicate the effects of price level changes. The latter is endorsed as more consistent

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6 "The fact that no basis of classification is free from objection, or permits clear-cut separation with no border-line cases, should not be too disturbing, as no scheme of arrangement in any field will satisfy every test." Paton and Paton, Corporation Accounts and Statements, p. 600.
with over-all utility at the present time. Adjustments for price level changes when presented in supplementary statements should be all-inclusive, that is, all items on the income statement and balance sheet should be brought up to a current uniform-dollar. The price level differential should be clearly identified and the supplementary reports should be reconcilable with the primary statements.

The balance sheet should be critically analyzed in view of the increased emphasis which has occurred in the area of income determination. It should be made consistent in contents, valuation, and arrangement with the primary aim of financial reporting --- reporting to investors --- so that it will regain its rightful place as a vital component thereof. Thus it will serve as a means of further improving income determination, serve as a useful basis with which to evaluate income, and constitute a useful factor in indicating future activity.
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J. Herman Brasseaux, son of Lezia and Eula Fontenot Brasseaux, was born on the twenty-sixth day of October, 1929, in Church Point, Louisiana.

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EXAMINATION AND THESIS REPORT

Candidate:  J. Herman Brasseaux
Major Field:  Accounting
Title of Thesis:  An Analysis of the Balance Sheet in View of Recent Emphasis on Income Determination

Approved:

[Signatures of Major Professor and Chairman, Dean of the Graduate School]

EXAMINING COMMITTEE:

[Signatures of committee members]

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