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Louisiana State University and Agricultural and Mechanical College, Ph.D., 1968 Accounting

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AN INVESTIGATION INTO THE NATURE, THEORY AND REPORTING OF EXECUTORY CONTRACTS

A Dissertation

Submitted to the Graduate Faculty of the Louisiana State University and Agricultural and Mechanical College in partial fulfillment of the requirements for the degree of Doctor of Philosophy

in The Department of Accounting

by

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B.S., University of Scranton, 1962
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ABSTRACT

Executory contracts are receiving increased attention, primarily because of the current controversy over leases. The same principles applicable to leases may also be applicable to other types of executory contracts. The accounting profession has recognized the existence of the problem posed by executory contracts as well as the need to study it. The problem centers around the question of whether or not data on executory contracts constitute relevant, useful financial information which should be reported in published financial statements.

The research entailed surveying current literature on various types of executory contracts to discover their present treatment in accounting practice and theory. No extensive empirical research was undertaken. This study explores five major problems, or attempts to accomplish five major objectives as follows:

1. To determine the present theoretical treatment of executory contracts and to trace the development of this theory. In this regard, unperformed
portions of executory contracts are not recognized currently as assets and liabilities in financial statements. This principle is derived from the writings of early authors who were concerned with only two forms of executory contracts, i.e., leases and purchase commitments. While executory contracts are not considered to be assets and liabilities, accountants have recognized that information on such contracts is highly relevant financial information which must be presented to users of financial statements.

2. To examine the adequacy of the current treatment of executory contracts when generally accepted accounting principles are applied to various contracts. The present practice of not capitalizing executory contracts is based primarily upon the concept of performance which, as presently defined and understood, has no less than seven major weaknesses, and is probably an inadequate theoretical basis. Footnote disclosure alone appears to be an inadequate method of reporting executory contracts, while the use of schedules seems to be a most useful reporting device.
3. To determine the objective of financial reporting and how executory contracts relate to that objective. The objective is to communicate to the interested user those elements of economic and financial information vital to his decision. Thus, the usefulness of the data is the primary criterion for determining what information should be reported in financial statements. On the basis of the usefulness of the data, executory contract information should be reported in financial statements. The method of reporting is, however, another matter.

4. To derive a consistent theoretical foundation which might accommodate executory contracts if they are capitalized. This is accomplished by adopting the concepts of assets and liabilities put forth by Sprouse and Moonitz in Accounting Research Study No. 3. Modification of the transactions concept and the concept of service potentials is necessary before these asset and liability concepts will accommodate executory contracts.

5. To investigate the effect of capitalization of executory contracts on selected financial ratios
as well as discussing briefly valuation problems and means of reporting such contracts other than by capitalization. Research indicates that replacement costs and price level changes can be applied to executory contracts with no special problems being created that are not already present when these concepts are applied to other assets and liabilities. Utilization of replacement cost for valuation of executory contracts has the unique advantage of further refining measurements of holding gains and losses. It is difficult to recommend capitalization of executory contracts, other than leases, on the basis of increased usefulness in the ratios studied. At the same time, however, the informational value of executory contracts dictates that they be reported, probably in separate schedules to financial statements.
CHAPTER I

INTRODUCTION

A brief survey of accounting literature reveals that little attention has been directed to the broad area of "executory contracts." This has also been true of particular types of executory contracts with the exception of lease contracts. The literature and research on leases in recent years have been voluminous. Conclusions of this research seem to indicate that some (and perhaps all) leases, in spite of their executory nature, should be reflected in the accounts and financial statements of lessees with corresponding adjustments on the books of lessors. This treatment, often referred to as the capitalization theory, appears to be gathering substantial authoritative support and was, in fact, partially adopted in Accounting Principles Board Opinions No. 5 (September, 1964) and No. 7 (May, 1966).

In spite of this support, there seems to be a reluctance on the part of many members of the accounting
profession to adopt such a treatment without first investigating the nature and importance of other types of executory contracts. This reluctance is noted in the comment of Walter R. Staub in Accounting Research Study No. 4:

I do not believe that these other contracts can be ignored in deciding whether or not to adopt the conclusions in the study, since to do so may lead to differing accounting practices where the same logical considerations appear to be applicable.¹

An investigation of the broad area of executory contracts is necessary in order to (1) decide whether or not the theoretical structure used to support capitalization of leases is also applicable to other types of executory contracts, and (2) aid in the development of a general theory of executory contracts.

**Purpose of the Study**

The purpose of this study does include an investigation of the capitalization theory of leases and the applicability of lease theory to other forms of executory contracts.

contracts. However, the primary purpose is not to substantiate or destroy lease capitalization. Such is to be accomplished only as an indirect result of this study. In addition, the research conducted on executory contracts to date must be summarized and the logical extension of the conclusions and results of this research must be pursued.

Assuming executory contracts of types other than leases are entered into to a large extent, it is of primary importance to consider the usefulness of incorporating these contracts in the body of the financial statements. It may be possible that improved disclosure in footnotes will be adequate recognition of such contracts and a simple solution to the problem. If the incorporation of executory contracts into the body of financial statements will provide useful, relevant financial information to statement readers, a theoretical structure must be formulated to serve as a guide in the analyzing and reporting of such contracts. In this connection it seems evident that a host of measurement problems will likewise have to be treated if recording of executory contracts is to be implemented.

In its first and broadest objective this research seeks to investigate the general nature of executory
contracts in an attempt to get some indication of the extent of their use by the modern corporation and, most important, to assess their importance to readers of financial statements. The importance of executory contracts should be a function of the extent to which such contracts meet the criteria for "accounting information" and the extent to which such information qualifies as relevant, useful financial data. Further, the objective is not to determine what the accounting treatment is, but rather what treatment should be accorded executory contracts.

After considering what accounting treatment should be given such contracts, a second, and directly related, objective of this research must be accomplished. This objective is the investigation of the adequacy of current accounting theory and practice with respect to executory contracts. Since current theory and practice do not provide for the recognition of executory contracts, the study must consider whether current theory and practice can be modified to include such recognition. This involves three phases:

1) deriving a consistent theoretical foundation which will serve as a basis for developing the accounting treatment which
it is determined should be accorded executory contracts;
(2) deriving new, different or expanded financial reporting concepts which will incorporate or satisfactorily accommodate executory contracts;
(3) determining the adequacy of current or available measurement techniques to meet the requirements of a newly formulated accounting theory and practice for executory contracts.

Scope of Study

This study is a theoretical investigation of executory contracts. Inquiry is made into present theory as well as the historical development of this theory. Any new, different or expanded theoretical concepts and principles necessary to support the treatment deemed most useful are developed and presented. In short, there are few, if any, limitations on the theoretical investigation.

Furthermore, the rights and obligations of both
parties to the contract are discussed. For example, unless otherwise indicated, the discussion is from the point of view of both the lessor and lessee under a lease contract, the purchaser and seller under a purchase or sales contract, the subscriber, as well as the corporation, under a stock subscription contract, and so forth.

No extensive empirical research on any particular types or forms of executory contracts is undertaken. Some thought was given to the possibility of making such an inquiry, but after some preliminary research on a few types of contracts (purchase commitments and construction contracts), this approach was abandoned. The main difficulties are that:

1. There are a tremendous number of contracts into which any corporation enters. Collection of original, empirical data on all forms is not possible. After considering the collection of such data, it did not seem to be necessary since such data serve to establish the need for considering executory contracts. On the other hand, it may be taken for granted that modern-day corporations are involved in numerous executory contracts, such as leases, purchase commitments, stock options, pensions and similar
contracts--their importance or materiality in terms of dollar value is assumed in this study.

2. Statistical data on few, if any, of these contracts are available. An attempt was made to obtain statistical data (volume and dollar value of contracts) on purchase commitments, with little success, except to establish that such contracts are common and important. Other writers also indicate that this type of data on leases is not available.² Likewise, just as in the case of leases, any attempt to derive an overall estimate of the impact of the capitalization of executory contracts must, of necessity, be partially deferred until reporting of these items becomes more extensive.³

3. Even with a particular type of executory contract, for example, purchase commitments, the myriad forms which the contract might take or the variety of terms which the contract might include, are limited only by man's ingenuity.


³Ibid., p. 69.
A few types of contracts could have been selected for detailed study and empirical data might have been collected on them. However, to investigate in detail two or three types of contracts which would be expected to be material in amount would have the same failings as the current literature on leases with respect to the objective of development of a general theory of executory contracts. Contracts which are material in amount are somewhat emphasized in the discussion and are often used when examples are needed to serve as a basis for discussion, but the comments and theory are intended to have general applicability.

Organization of Study

Chapter I serves to introduce the topic briefly and to present the scope and limitations of the research. In addition, a sketch of the order of presentation and the organization of the study is set forth.

Chapter II defines the topic in greater detail and orients the reader to the main problems presented by executory contracts. In addition to defining the problem further, a brief historical review is presented which traces the development of current principles for handling executory contracts.
In Chapter III, the main task accomplished is a demonstration of the need for the study by bringing the problems into sharper focus. Such a need is based primarily upon the conceptual inconsistencies or inadequacies of the current treatment. Some examples of recent presentations of executory contracts in annual reports are included to give some indication of the materiality of the items involved, as well as the manner of presentation.

Chapter IV examines executory contracts in terms of what might be called the basic objectives of accounting. These objectives include the objective of financial reporting and the basic function which the balance sheet and income statement should serve. Directly related to the function of financial statements is the determination of the criteria which should be used in establishing which data should or should not be properly termed accounting information. Another basic issue treated in Chapter IV is the degree or extent of predictability which should be contained in financial statements.

Chapter IV seeks to examine executory contracts in light of the ends or objectives which accounting is or should be achieving. Chapter V, on the other hand, views
executory contracts in terms of the means to be used in accomplishing these objectives or ends of accounting. Means refers to the various basic concepts or principles which should serve as guides to achieving the objectives of financial accounting. Some of the more extensively treated items in this chapter are asset and liability concepts, the accrual concept, going concern concept, title transfer principles, and objectivity. Chapters IV and V are, in short, an attempt to show the place which executory contracts should hold in financial accounting theory and to present what might be called a financial reporting model which accommodates executory contracts.

Although the theoretical and practical need for presentation of executory contracts in financial statements may be demonstrated, there are still a host of valuation problems and difficulties of actual presentation which must be encountered. This is the subject matter of Chapter VI. Possible valuation bases are investigated and, in some cases, their application to specific contracts is illustrated. In addition, the effect of executory contracts on general financial statement analysis and traditional ratio analysis is presented.
Chapter VII, the final chapter, presents a summary of what has been said in the previous chapters and draws some general conclusions. Also presented in this chapter are recommendations for further research needed before the general conclusions can be implemented.

**Definition of Subject Matter**

Basically, the subject matter of this study is contracts. A contract has been defined as "an agreement enforceable by law..." or

... an agreement (expression of mutual assent) between two or more competent persons, having for its purpose a legal object, wherein each of the persons acts in a certain manner or promises to act or refrain from acting in such a manner.\(^4\)

As is generally understood, a contract is composed of four major elements:

1. An **agreement** which is made up of an **offer** by one party and **acceptance** by another party.

---

(2) **Consideration** which is the price paid by each party to the other or what each party gives up in the agreement.

(3) **Competent parties** which means that the parties must possess legal capacity to contract, i.e., be of legal age and sane.

(4) A **legal object or purpose** consistent with law and sound policy.

More precisely, concern is with executory contracts. An **executory contract** is one that is yet to be performed or one wherein a party binds himself to do, or not to do, a particular thing. An **executed contract** on the other hand is one in which nothing remains to be done by either of the parties or one in which the object of the agreement is performed and everything that was to be done, according to the terms of the contract or agreement, is done.

A contract may be partly executed and partly executory, and may be executory as to one party and executed as to another. In other words, the terms **executed** and **executory** may be used to describe different stages of the same contract.

It might be stated that executed contracts are not
properly contracts at all, since the parties are no longer bound by contractual ties. In a sense then, all contracts are executory since when they cease to be executory they cease to be contracts. Taking this point of view, the subject matter might be more properly termed "contractual commitments" rather than "executory contracts."

To avoid getting involved in legalistic definitions and without quibbling over terminology, the subject matter will be labeled contractual commitments or executory contracts, using the terms interchangeably to refer to contracts or agreements under which performance is not complete by one or both parties.

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CHAPTER II

RECENT VIEWS AND HISTORICAL DEVELOPMENT
OF EXECUTORY CONTRACT THEORY

Before examining the adequacy of the current theory of executory contracts, it will be helpful to define further the main problems presented by executory contracts and to review some of the recent opinions of current writers concerning such contracts. In addition, a brief historical review of the development of current generally accepted accounting principles with respect to executory contracts will be helpful in assessing the adequacy of these current principles.

Accounting Research Study No. 4

As was mentioned previously in Chapter I, many members of the accounting profession are hesitant to capitalize leases without first considering other types of executory contracts. For example, Ira A. Schur, a member of the project advisory committee, pointed out in Accounting Research Study No. 4:
As a matter of theory, I question whether any such departure from established principles of balance-sheet preparation should be advocated without thoroughly considering (a) the theory of commitments in general and (b) the basic function of the balance sheet. These two questions are fundamental to the question of leases.¹

Other writers are also beginning to compare the similarity of leases to other types of executory contracts. Most of the opponents of lease capitalization attempt to draw parallels between leases and other forms of contractual commitments. The objective of such a comparative process is to show that it is inconsistent to capitalize leases, while at the same time ignoring other contractual commitments which possess the same characteristics as leases. Professor Myers recognized this problem in Accounting Research Study No. 4 as one of the five objections to capitalization of long-term leases in financial statements. Myers states:

The third objection seems to be a technical accounting one. It takes the form of saying that balance sheet treatment of lease commitments should be deferred until we have investigated all other commitments to see if and to what extent they should be disclosed on the

balance sheet. On the contrary, however, improvements must be made and recognized if progress and evolution are to take place. Commitments under bond contracts have long been recognized as ones which should be shown on the balance sheet at their present (discounted) value—a value which on date of issue is equal to cash proceeds received. The finance element of lease contracts is but little different from a bond contract to the going concern. Other commitments have not been investigated to any great extent, but they appear to be different in certain essentials from lease contracts.\(^2\)

Some writers would not agree with Professor Myers that "other commitments appear to be different in certain essentials." In addition, this conclusion would be difficult for Myers to establish since no substantial research has been conducted on these other commitments. It should be pointed out that Professor Myers was not charged with such an investigation of other commitments, nor does he suggest that Accounting Research Study No. 4 is such an investigation.

**Extension of Lease Theory**

Some authors are in direct conflict with Myers'

statement concerning the treatment to be accorded other
types of contractual commitments. Generally, the argument
seems to be that if it is acceptable to capitalize the con­
tractual right to used leased property then it must also be
acceptable to capitalize other contract rights. Thus, it
would seem to be valid to capitalize the numerous other
forms of executory contracts. Following this same line of
reasoning, Alvin Zises, one often-quoted opponent of lease
capitalization, makes a convincing case for the similarity
of leases and contracts to purchase electric power. He con­
cludes that there should be little difference in the disclo­
sure of a firm twenty-five year purchase power agreement and
a firm twenty-five year lease on the generating station which
produces the power. Zises concludes that capitalization of
contractual commitments should be approached with extreme
caution. The implication is, of course, that the subject
should, in fact, be approached or investigated—the task to be

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3 Charles G. Walker, "Capitalization of Executory Con­
tracts and Commitments," Louisiana Certified Public Account­
ants Review (October, 1966), p. 49.

4 Alvin Zises, "Disclosure of Long-Term Leases," The
taken up in this dissertation.

Shillinglaw, who favors not only capitalization of leases, but also extension of capitalization to other forms of contractual commitments, goes a bit further than merely citing the problem and suggests (1) some guides for determining which contracts should and which should not be capitalized, and (2) some contracts which should be capitalized. In this regard Shillinglaw says that:

"... if there is a firm contract, giving each party valid, enforceable claims against the other and if the contract is of a sufficient length to make the dollar equivalent of the claims become material, then the contract should be capitalized."^5

Applying this principle to specific cases, Shillinglaw discusses certain contracts which might be capitalized. They include an agreement whereby an employee, after separation from a company, agrees not to compete with the company for a given number of years, and also a management employment contract, whereby an executive agrees to serve in a given capacity for a specified period of time. Clearly, Shillinglaw's


ideas extend beyond the current generally accepted accounting principles with respect to executory contracts.

Two very interesting articles have appeared subsequent to the issuance of Accounting Research Study No. 4, which advocate capitalization of long-term purchase commitments. The purchase contracts are, however, of different types. The most recent of these articles makes a strong case for capitalizing long-term purchase commitments for raw materials that were entered into in an arms-length transaction, e.g., an agreement with an unrelated supplier to purchase a given quantity of coal or gas, and so forth, at fixed prices.7

The other article treats commitments between related companies to purchase raw materials, power and transportation facilities where the purchase contracts are used as primary security to guarantee large investments by outsiders in subsidiary corporations.8 Again a convincing case is


made for the capitalization of such long-term purchase contracts.

**Need for Research on Executory Contracts**

The preceding discussion clearly indicates that the results and conclusions of Accounting Research Study No. 4 and Accounting Principles Board Opinion No. 5 have some applicability to other types of contractual commitments. Rather than attempting to handle executory contracts on an ad hoc basis, the comments of Meyers, Schur and Staub indicate that a broader investigation of executory contracts needs to be conducted. In addition, the 1966 American Accounting Association Committee to Prepare a Basic Statement of Accounting Theory seems to have recognized the problems posed by executory contracts.⁹

Although most of the relevant articles to date have been primarily concerned with the problem of lease capitalization, research in the area of executory contracts is necessary to satisfy a much broader objective than simply

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substantiating lease capitalization. Or, as one recent writer stated:

In the absence of a new accounting theory which encompasses the entire area of commitments, the capitalization of leases will only add confusion to financial statements when the objective of change should be clarity. Hopefully the discussion and controversy generated by the lease capitalization proposal will be beneficial to the accounting profession. This will be true if it leads to a thorough study of the entire area of commitments.\(^\text{10}\)

Rather, an investigation must be made to see if the profession should depart from the legalistic concepts so heavily relied on in financial reporting and to determine whether or not financial reporting should be extended to include executory contracts, at least those which are material enough in amount to qualify as relevant financial information.

The possibility of recognition of executory contracts questions the very basic purposes of financial statements and financial reporting and, in addition, may dictate expansion of basic, generally accepted accounting and reporting concepts in use today. Other issues underlying this problem are, the degree of predictability which financial statements should contain and the advisability of basing accounting

\(^{10}\text{Lauver, op. cit., pp. 350-51.}\)
principles on legal concepts. In addition, the problem implies, at a minimum, different or expanded concepts of assets and liabilities, a new concept of an accounting transaction and extension of the accrual concept.

**Historical Review**

Anyone attempting to look at executory contracts in an historical perspective is immediately confronted with several difficulties. In the first place, the first official pronouncement of the American Institute of Accountants did not take place until 1939. Hence, one must look to the unofficial literature to determine the attitude of professional accountants toward executory contracts prior to that time. Secondly, research confirms that not very much has ever been said about executory contracts, per se. Certainly, there has never been a very comprehensive, theoretical statement on executory contracts. Rather, the current generally accepted accounting principles, with respect to executory contracts, seem to be based upon the traditional treatment of a few specific items, most notably, purchase commitments. For this reason, one must look to the theory of handling these specific items in order to trace the thoughts
leading to the current view of executory contracts.

Sprague, in 1910, in his "Philosophy of Accounts," was one of the earlier writers to refer to the place of executory contracts in accounting. This reference is contained in his definition of assets:

... assets comprising the debit side of a balance sheet may be considered in one or more of the following ways: 1.) ..., 2.) ..., 3.) as incomplete contracts, where of our part has been performed in whole or in part; or contractual assets.¹¹

Further, Sprague indicates that assets and liabilities arise out of performance under contract:

Rights always arise from uncompleted contracts. No man owes you unless there has been a contract, tacit or exprest, oral or written, for you to give him something and for you to give him something. If one of you has fulfilled his part of the contract, that one has acquired a right and the other has incurred an obligation.¹²

Arthur Lowes Dickinson, writing in 1913, expressed similar ideas on the concept of performance under contracts. However, he was speaking in the context of liabilities on contracts for purchase or sale for future delivery:


¹²Ibid., p. 41.
... those made at fixed prices for future requirements of the business ... are usually ignored altogether, on the ground that the contracts are made in the ordinary course of business and that no liability really does arise until the other party to the contract performs his part of it; and inasmuch as, until performance, the actual value of the corresponding asset may usually be taken as equal to the liability value, this treatment is safe. Circumstances might ... require the creation of some reserve or even justify an asset value in excess of the liability.13

Writers in the early 1920's seemed to have a good deal more to say about purchase commitments and firm sales commitments than did earlier authors. This increased attention may have been due to the general economic conditions leading up to the market crash of 1929 and what one writer called an "inventory crisis" that "permanently influenced accounting practice."14 Apparently, in this inventory crisis of 1921, many merchants had forward contracts for both purchases and sales at prices above the current market. With a decline in inventory prices they were compelled to perform on their purchase contracts, while on their balancing sales contracts,


their choice was to agree to cancellation or to incur a bad debt. Those merchants who had only future purchase commitments were in the same predicament. For example, in the case of Goodyear Tire and Rubber Company in their May 1, 1921 balance sheet, a reserve of $24,000,000 was made for losses on commitments, in addition to an $18,000,000 reduction in inventories from cost to market. In view of the circumstances just discussed, it is not surprising that during the early 1920's, most writers were concerned with one aspect of purchase and sales commitments, i.e., losses on such contracts.\(^{15}\)

Kester suggested that goods under firm sales commitments (purchase commitments) should/ (should not) be included in the "inventory" of the seller/ (buyer) unless title has passed.\(^{16}\) However, due to the "importance of purchase commitments from the standpoint of financial position," it is necessary that they be given some recognition. Accordingly, two methods were recommended for treating purchase commitments:

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\(^{15}\)For example, see Homer N. Sweet, "Treatment of Commitments of Purchasers, etc., on Certified Balance Sheets," The Journal of Accountancy (March, 1921), pp. 167-72.

(1) footnote disclosure—which Kester preferred because it was "less cumbersome," or

(2) bringing the commitments on to the face of the balance sheet by debiting "Goods on Order" and crediting "Purchase Commitments" for a like amount.

In the case of firm sales commitments, similar treatment was recommended, i.e., footnote disclosure or memorandum record. Kester also points out that large manufacturers (for example, U. S. Steel and General Electric Company) always report "bookings" or unfilled orders" as an essential part of their periodic statements.

In the case of goods made to order, rather than for inventory, Kester maintains that the "conditions of profit taking are changed." In this instance he maintains:

... the sale has been made for delivery of the product at some future time named or left indefinite. While, of course cancellation is possible before date of delivery and acceptance ...

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17 In the case of purchase commitments, when speaking of a "memorandum record," Kester meant bringing an asset and liability on to the balance sheet. He is not explicit in the case of sales commitments.

18 Kester, op. cit., pp. 146-47.
Cancellation is not possible without incurrence of damages or being held to specific performance. Under these circumstances it is apparent that, within reasonable limits, a portion of the profit may be taken up in the current period . . . 19

In the case of purchase commitments, Kester's reasoning is based upon the legal principle of passage of title. Likewise, in the case of the sales contract, Kester's reasoning is based on the legal position of the selling company, who having performed under the contract, is, at a minimum, entitled to damages for breach of contract or specific performance. In contrast, profits on goods awaiting delivery (which had been manufactured to stock) should not be taken up until delivery has been made, because of the common trade practice of allowing cancellations right up to, and even beyond, the shipment date. 20

Canning is more theoretical than previous writers with respect to executory contracts. In his asset definition, he would exclude from assets . . . income or services expected to accrue under contracts wholly executory and unperformed on both sides and under the wholly unperformed portions

19 Ibid., pp. 415-16.
20 Ibid., pp. 417-18.
of contracts, provided both sides are equally unperformed.\textsuperscript{21}

Likewise, no liability would be reflected in this case.\textsuperscript{22}

Canning then makes reference to wholly unperformed executory contracts. He indicates that an asset must consist of not only "rights" to future incomes or services, but, also, "enforceable rights." Even then, however, not all enforceable rights are assets,

\textellipsis if with the receipt of each increment of service there is a concurrent and equivalent obligation to render an offsetting service, accountants omit the receivable income from the list of assets.\textsuperscript{23}

He illustrates the application of this principle by showing that under a one-year lease for a building, no asset will ever appear on the lessee's books (unless rent is paid in advance) and no asset will ever appear on the lessor's books for rent (unless rent is due but unpaid).

Canning is careful to distinguish wholly executory contracts where the services to be rendered, in terms of


\textsuperscript{22}\textit{Ibid.}, p. 56.

\textsuperscript{23}\textit{Ibid.}, p. 18.
both time and amount of value, are not always equal. 24 Hence, he states that to omit a favorable purchase commitment from assets is to make a "balance sheet show a financial position less favorable than that which exists" and to omit the effect of this same contract from the balance sheet of the supplier "allows him to make an unduly favorable showing." He distinguishes another "class" of executory contracts, i.e., those involving unequal part performance. The most common example of this type contract is one where delivery of goods purchased on account, has taken place. Assets, liabilities and income would be recognized to the extent the performance was unequal.

Canning felt it necessary to refer to purchase commitments later in his discussion of liabilities where he indicates that:

... signs are not wanting, however, to indicate that changes in practice may shortly become general that will give more inclusive meanings both to assets and to liabilities. Sporadic instances are found of balance sheets exhibiting such items among the assets as:

24 Ibid., p. 18.
Purchase commitments not yet filled $10,000
Less contingent loss at prices (date) 2,000 $8,000

and among liabilities a corresponding item of:

Purchase commitments $10,000

That is to say, some accountants are beginning to list, as assets and as liabilities, the services to be had and the services to be performed under wholly unperformed contracts. This is especially true where, as above, a substantial loss on the order for future delivery seems probable at the state of the balance sheet . . . . There are great possibilities of usefulness in the extension of this practice. 25

In the few years immediately after Canning wrote The Economics of Accountancy, little seems to have been said about executory contracts, per se. Rather the focus of attention seems to have been on probable losses on purchase commitments which were not balanced by enforceable sales commitments. The reason for this emphasis is probably contained in the following statement by Montgomery, which refers to an apparent second inventory crisis.

On December 31, 1929, to 1931, inclusive, many concerns had outstanding commitments to receive goods and materials at prices much higher than the prices current at those times. As it was

25 Ibid., p. 57.
hoped that the downward price trend would shortly be arrested, the apparent loss was not taken up by most concerns in their accounts at December 31. 

Montgomery suggests that part of the responsibility for failing to take up this loss, rests with the United States Treasury Department which promulgated a ruling that goods could not be included in the inventory of the buyer unless title had passed. This situation apparently led Montgomery and others to firmly recommend footnote disclosure and make the often-quoted statement that:

It is not general practice to show future commitments (sales or purchases) in certified balance sheets, and until it becomes fairly general, it cannot be considered good accounting practice to insist upon it, but, 'whenever the information is essential to the understanding of a true financial position,' (emphasis supplied) it must be done.

What might be dubbed the third "inventory crisis" took place in the closing months of 1937 and roused concern of the Committee on Stock List of the New York Stock Exchange,


27 Regulations 77, Article 10.

28 Montgomery, op. cit., p. 381.
which, after conferring with the American Institute of Accountants Committee on Cooperation with Stock Exchanges, issued a letter in January of 1938. The letter, addressed to the presidents of listed corporations, emphasized that it would be desirable for such corporations to advise their stockholders as to whether or not the corporation enters into commitments which are material factors in the company's financial position. In any instance where material losses were anticipated on these commitments, a reserve for such losses should be set up or adequate disclosure should be made.

This letter was probably the forerunner of Accounting Research Bulletin No. 29, issued in July, 1949, on Inventory Pricing which states that:

Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement.


\[30\] Accounting Research Bulletin No. 29 is now Chapter 4 of Accounting Research Bulletin No. 43 (New York: American Institute of Certified Public Accountants, 1961), p. 34.
Viewing the preceding discussion, it is not difficult to understand the origin of the current theory of executory contracts. The following statements, according to Accounting Principles Board Opinion No. 5, describe generally accepted accounting principles with respect to executory contracts:

The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.

The rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. Generally accepted accounting principles require disclosure of the rights and obligations under executory contracts in separate schedules or notes to the financial statements if the omission of this information would tend to make the financial statements misleading. 31

Observations on Historical Development

It is interesting to note that the current treatment of executory contracts recommended by the American Institute of Certified Public Accountants is but little different from that suggested by early writers as far back as Sprague. In this sense, little progress has been made with the concepts of executory contracts. Admittedly, although a few writers currently suggest it, no "official" pronouncement recommends bringing sales and/or purchase commitments onto the face of the balance sheet. Of course, capitalization of leases, as executory contracts, was not recommended by any of the early writers, as was pointed out previously. Such recognition was a later development, officially sanctioned in Accounting Research Bulletin No. 38, published in 1949.

In addition, the theory of executory contracts, both past and present, is expressed very much in terms of leases and purchase commitments. That this is the case is further supported by the fact that even long-term construction contracts have been discussed historically, in terms of the amount of profit to be recognized on them, rather than as executory contracts. The only note in connection with
construction contracts is that, according to present, as well as past writers, profit is to be recognized on the basis of performance or the portion completed.  

The theory of executory contracts, both past and present, is heavily influenced by the legal concepts of performance and title passage. This influence is probably the result of attacking specific problem areas rather than attempting to solve specific problems by derivation of general theoretical solutions. This ad hoc approach is still recommended by some writers as a way to solve the problem of which executory contracts should be capitalized. In other words, it is recommended that accountants look at the more important contracts in a vacuum and derive a solution contract by contract, rather than deriving a general theory of executory contracts which will be ready for application to all contracts as their importance increases.

The main conclusion of this brief review of history is that the case of executory contracts is one wherein accountants have been faced with the dilemma of having to

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adhere to (or at least there seems to be a compulsion to rely on) legal concepts and principles in financial statement presentations. At the same time, it is recognized that assets and liabilities exist, in addition to those legal, enforceable rights, which are relevant financial information and which, as a consequence, must be presented to stockholders.
CHAPTER III

ADEQUACY OF CURRENT THEORY OF EXECUTORY CONTRACTS

The current theory of executory contracts relies heavily on the concept of performance under contract. The present chapter examines the adequacy of the existing concept of performance as a basis for the recognition or non-recognition of executory contracts as assets and liabilities. It is shown that the generally accepted accounting principles for handling executory contracts enunciated in the previous chapter are not always applied to the treatment of all executory contracts. In addition, subsequent discussions suggest that if the existing concept of performance is to be used as the sole theoretical basis for handling executory contracts, it must be further explored and related to overall objectives of accounting and financial reporting. In addition, it seems that the issue of executory contracts must be examined in terms of the basic purposes and objectives of accounting, before an adequate theoretical base can be developed.
Corporations' Use of Contracts

Contracts are made frequently and have become such an integral part of the day-to-day operations of business enterprises that one often fails to realize when they are made, when they are performed and their large numbers. One writer has very aptly described the modern day corporation as a "bundle of contracts." Accordingly, the activities of any "going-concern" are characterized by the innumerable contracts into which the corporation has entered. This bundle of contracts includes contracts, both oral and written, for the purchase and sale of goods and services; contracts for the lease of both real and personal property, employment contracts, bond contracts, and all the other myriad types and varieties of contracts that will be found to be in force in any dynamic enterprise. These contracts can cover any period ranging from a few short minutes to the entire life of the corporation.

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Accountants' View of Contracts

From among the wide range of contracts that a corporation customarily becomes a party to, the accountant recognizes some, but not others. For example, some contracts are recognized upon execution of the agreement or upon entering into the contract. Examples are: the variety of sales contracts (ranging from a sale on account to conditional sales contracts), bond contracts, stock subscription contracts, and contracts for pensions and retirement. On the other hand, the accountant has ignored other corporate contracts which are just as legally binding as those mentioned above. Included in this group are some leases, employment contracts, long-term construction contracts and purchase commitments. These different practices lead to one of the primary issues of this study, which is a determination of the basis or bases for either the recognition or nonrecognition by the accountant, of contractual commitments or executory contracts.

Classification of Contracts

Why are some contractual commitments recognized while
others are not? Is there any logic or consistency to the
treatment accorded these contracts by the accounting profes­
sion? Just as the auditor would expect consistency in the
application of principles from one period to the next, so
also, the theorist has a right to expect consistency in the
treatment of all executory contracts. One would expect there
to be a basic theory of executory contracts as a whole, rather
than simply being satisfied with a different, but, consistent
treatment of particular contracts from one period to
another.

In an attempt to provide an answer to these and other
questions and to give some indication of present practice,
perhaps it would be useful to classify contracts into the
following categories:

(1) those recognized by the accountant in the
accounts,

(2) those recognized by the accountant in foot­
notes,

(3) those not recognized by the accountant until
they cease to be contracts.

Accordingly, the following tabulation is a list of contracts
which are commonly encountered by business firms. The list
is obviously not exhaustive and, as might be expected, some contracts fall into two categories because they are given recognition in both the accounts and footnotes. Bonds are an example of this type situation. Some contracts, such as leases, fall into all three categories, since sometimes they are recognized in the accounts; at other times only in the footnotes and most often not at all.

**Contracts Recognized in the Accounts**

1. Sales contracts—ranging from an oral sale on account to sales under various types of conditional sales contracts extending over long periods of time.

2. Short term purchase contracts—i.e., regular purchases on account and then only if title has legally passed.

3. Stock subscription contracts.

4. Pensions.

5. Contracts for product guarantee.

6. Some lease contracts—only those that can be considered installment purchases.

7. Bond contracts and other types of negotiable
instruments.

(8) Patents.

Contracts Recognized in Footnotes

(1) Leases.

(2) Some purchase commitments—for inventory, supplies, real estate, and so forth; generally only to the extent of stating no material loss on such contracts is anticipated.

(3) Various employee benefit contracts—including such contracts as annuities, bonuses, deferred or contingent compensation, incentive compensation, pensions, profit sharing agreements, retirements, stock bonuses, stock options, stock purchase plans, and similar type contracts.

(4) Long-term construction contracts—including public and government contracts with the corporation as either the buyer of construction or the contractor.

Contracts Not Recognized in Footnotes or Accounts

(1) Leases—most leases fall into this category.
(2) Purchase contracts--for investments, inventory, supplies, real estate and other fixed assets.

(3) Management employment contracts.

(4) Guaranteed annual wage contracts.

(5) Research and development contracts.

(6) Long-term construction contracts.

(7) Advertising contracts.

(8) Maintenance and service contracts.

Accounting for and Reporting Executory Contracts

It would be well to examine a few contracts from each classification to determine if there is a sound theory which can be applied to their treatment with any degree of consistency. The sheer number and dollar value of the contractual commitments just listed dictates that a solid theoretical and practical basis is necessary for the handling of these contracts. Prior to such an investigation, however, the current accounting principles and reporting practices with respect to executory contracts should be set forth as a basis for subsequent discussion.

According to the American Institute of Certified
Public Accountants, executory contracts should be treated in accordance with the statement from Opinion No. 5, previously quoted in Chapter II. In brief, unperformed portions of executory contracts are not recognized as assets and liabilities, but disclosure of such contracts in footnotes or separate schedules is required if their omission would tend to make financial statements misleading.2

The SEC position on contractual commitments is, in substance, the same as that of the American Institute of Certified Public Accountants, i.e., it is essentially a disclosure requirement. S-X Regulations provide in Rule 3.18:

(a) If material in amount the pertinent facts relative to firm commitments for the acquisition of permanent investments and fixed assets and for the purchase, repurchase, construction or rental of assets under long-term leases shall be stated briefly in the balance sheet or in footnotes referred to therein.3

Other official pronouncements have been made by the

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American Institute of Certified Public Accountants on particular types of executory contracts (e.g., pensions and long-term construction contracts), but, they: (1) are concerned primarily with revenue and expense recognition, and (2) do not set forth principles which are intended to have general applicability to executory contracts. Indeed, this is the problem in the first place.

The preceding are the "official" rules, guides or principles governing the accounting treatment to be accorded executory contracts. There are basically two concepts involved: (1) performance, and (2) a potentially misleading effect. The application of these concepts to a few selected contractual commitments should be examined.

**Extent of Performance**

Examining the results of applying generally accepted accounting principles to the three categories of contracts listed previously yields some interesting results. Apparently, generally accepted accounting principles dictate that a corporation should recognize assets and liabilities in connection with executory contracts to the extent that the corporation under consideration has performed under
the contract. In other words, the issue is one of extent of performance, or in the case of nonperformance, whether the omission of the contract would tend to make the statements misleading. Contracts, then, are to be recorded in the accounts to the extent that the parties have performed. Some contracts are fully performed in one act, while others require several or a series of acts to complete. It would seem that if either of the parties to the contract had fully performed, while the other party had not performed at all, the total contract should be recognized by both parties as an asset and liability.

**Sale or Purchase on Account**

Presumably, a regular sale on account would give rise to an asset because the selling corporation has completely performed in delivering the merchandise to the customer. Likewise, a regular purchase on account by the same corporation would give rise to an asset and liability because the other selling corporation has performed by delivery. In other words, the contract has, in each of the above cases, been fully performed by one of the parties. For this reason, the contract is recognized in the accounts of both the
parties, in full, as an asset and liability.

In the case of most sales, there is a tendency to equate performance with delivery. Two cases can be cited. The first case concerns an order for a special product, placed under contract, where the manufacturer has produced a portion of the goods, thereby justifying, according to some accountants, the recognition of a portion of the revenue under the contract. If such performance by the manufacturer gives rise to assets and corresponding revenue, so also, the same performance should give rise to corresponding assets and corresponding liabilities by the other party to the contract (purchaser). However, this does not take place in practice because delivery has not taken place and legal title has not passed. The extent of performance is, in effect, differently recognized and valued by each party.

The second case also assumes an order (contract) is received by a manufacturer to sell a product. The order is not accompanied by a cash payment. According to generally accepted accounting principles, the order is not recorded as an asset and corresponding revenue or liability amount because the order can generally be cancelled prior to delivery. In addition, if the manufacturer has performed
no service, he has no claim on the cancelling company. In terms of information communicated, this policy can be very costly. For example, Sears, in their annual report for fiscal 1966 had $1.2 billion of merchandise on order and in-transit. This fact was not disclosed in either the financial statements or its accompanying notes. Certainly, not even a material amount of these orders will be cancelled.

One author suggests that the economic event of obtaining an order or contract constitutes performance which should be recorded. This might be especially true where the sales effort in connection with the order is substantial and may, in fact, be the major economic event or "critical event" in the production of income. At one point, this author states the crux of the matter.

It is true that the selling company has not yet performed in a manner to benefit the purchaser (except possibly to inform him of the virtues of the product being sold), but an economic function—namely, obtaining an order—has been performed, and this should be recorded.

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5Ibid.
What this writer is calling an economic function, however, may be performance under an executory contract. Clearly, the contract involved is not the sales contract under discussion, since the performance involved took place prior to the formation of the sales contract. Such performance does give rise to legal rights and obligations, and may constitute performance: (1) under an employment contract between the manufacturer and one of its salesmen, or (2) under a security contract between the corporation and its stockholders. The sales effort required to acquire the order in question might be viewed as performance by the corporation under the executory contract between the corporation and its stockholders, whereby the corporation in return for invested capital, agrees to carry on certain activities in the interest of stockholders.

A Narrow View of Performance

Possibly accountants are taking too narrow a view, or have taken what might perhaps be called a "compartmentalized" view of performance under executory contracts. Activities conducted to create one contract can constitute performance under another contract. If a very broad approach
is taken and a corporation is viewed as a "bundle of contracts," probably all activity performed by a corporation or its agents can be construed as being performance under an executory contract.

Whether or not accountants consider the rights and obligations arising as a result of either the salesman's or corporation's performance (in the last example) to be assets and liabilities respectively, will, of course, depend upon what one considers an asset and liability to be. What constitutes performance in the ordinary or economic sense is not necessarily performance in the legal sense, and thus may not give rise to a legal claim or asset. This fact would have to be determined under the law. The question for accountants however, becomes: is accounting concerned with performance only in the legal sense, i.e., only that performance creating legal rights and obligations supported by the law, or is accounting also interested in reflecting performance in the economic sense of activity which has economic value?

 Particularly when revenue is involved, accountants have long recognized economic performance, in spite of the fact that an asset has not been created by legal contract.
For example, Chapter 4 of Accounting Research Bulletin No. 43 states:

It is generally recognized that income accrues only at the time of sale, and that gains may not be anticipated by reflecting assets at their current sales prices. For certain articles, however, exceptions are permissible. Inventories of gold and silver, when there is an effective government-controlled market at fixed monetary value, are ordinarily reflected at selling prices. A similar treatment is not uncommon for inventories representing agricultural, mineral and other products, units of which are interchangeable and have an immediate marketability.  

Clearly, the accountant recognizes more than the legal facts of transactions. In effect, Accounting Research Bulletin No. 43 permits recognition of assets and revenue prior to the formation of a sales contract. Production prior to sale can hardly be construed as performance under a sales contract since technically, a sales contract does not yet exist. Such treatment of the above contracts might justify, in turn, recording of inventories at selling prices when a firm order for the goods or a purchase contract is received. Certainly, this procedure could not be objected

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to on the basis of failure of performance.

Legal Point of View

When considering performance under executory contracts, it should be noted that a contract is a legal object, i.e., it is created under the law. In a sense then, when one speaks of executory contracts, he is immediately and completely within a legal domain, which in turn invokes or brings into play, all the legal concepts and principles of rights and obligations under the law. If assets are equated with these legal rights, and liabilities are equated with these legal obligations, there would seem to be no difficulty in applying legal principles to determine the existence of assets and liabilities under executory contracts. In other words, assets and liabilities would be created under executory contracts when the legal right or obligation was created. The valuation of these assets and liabilities would, of course, be a separate, independent matter.

Should one then take this approach, it would seem that balance sheets would have to be limited to assets and liabilities under the law, i.e., the balance sheet would be essentially a legal determination. However, it is a
well-accepted fact that accounting seeks more than this legal objective, i.e., by definition it, seeks to communicate more than legal information and does not choose to ignore the other aspects of financial transactions. The equity method of carrying investments in subsidiaries is an illustration of this fact.

**Capital Stock Subscription Contracts**

In the case of capital stock subscriptions, stock is sold under subscription contracts which require payment by the subscriber at a later date. When stock is sold by means of subscriptions, a person wishing to become a stockholder signs a subscription blank or a subscription list on which he subscribes to a certain number of shares and agrees to pay for the stock, either in one amount or in installments. When the subscription is accepted by the corporation, it becomes a contract. Generally, the stock is not issued to the

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7In the case of an agreement to take shares, upon acceptance of the offer by the corporation, the subscriber becomes a shareholder. The shareholder, pursuant to the assent of the corporation, is under obligation to pay the subscription price of the shares. In contrast, an agreement to subscribe to shares in the future does not in itself imply acquisition of corporate membership, and therefore, in case of breach of the subscription contract, the corporation,
subscriber until the subscription contract has been fully paid. Following the traditional treatment, the subscription contract is regarded as an asset by the corporation and is recorded as a debit to an account, "subscriptions receivable." Accordingly, "subscriptions receivable" is treated as a current asset on financial statements. Some objection to this procedure is raised, as noted by Montgomery, however, the support is apparently for treating it as an asset. Such treatment is due first, to the fact that the "subscriptions receivable" is a realizable asset but secondly, and probably more importantly, because subscriptions are recognized as assets by the laws of most states. According to current

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theory, this contract is an asset since it represents a legal claim against subscribers, and also, because the corporation intends to collect the subscriptions within a definite period of time.\textsuperscript{10} If it is not intended that the contract be collected, or if the time of calling for payment is indefinite, the subscription is not an asset, according to Hendrikson. However,

\dots a valid commitment to invest and a reasonable expectation that the amounts will be paid into the corporation in due course should be sufficient to consider the subscriptions as permanent investments.\textsuperscript{11}

In this connection, two points should be considered: (1) if accountants were to recognize executory contracts on the basis of legal claims or rights, they would recognize many more than they do presently, since under all contracts legal rights or claims arise, and (2) the generally accepted accounting principles of extent of performance and potentially misleading effect, which were enunciated in Opinion No. 5 of the Accounting Principles Board, are not being


\textsuperscript{11}\textit{Ibid}.
applied to stock subscription contracts. Such a contract can be executory as to both parties and still be classified as an asset, i.e., neither party has to have performed for the subscription contract to be treated as an asset. Likewise, as a basis for recognition as an asset, no mention is ever made of the potentially misleading effect if the subscription contract is not recorded as an asset or reported in footnotes.

If stock subscription contracts were treated in accordance with current generally accepted accounting principles governing executory contracts, it would seem that if neither party has performed under the contract, there is neither an asset nor a liability on the part of either party. This rule is not applied to stock subscription contracts. Rather, according to Hendrikson, the basis used to justify a recording becomes one of the existence of a valid or legal claim or contract and the expectation or anticipation of performance under the contract.

Contracts to Invest

The line of reasoning used to justify recording of subscription contracts as assets on the books of the issuing
corporation, suggests that the subscriber, especially where the subscriber is another corporation, show an asset and corresponding liability for the contract. This treatment would also seem to require that commitments to invest in other corporations, in forms other than subscription contracts (such as commitments to purchase bonds or advance funds under notes), be recognized as assets and corresponding liabilities. No instances of such a practice could be found in the 1966 edition of Accounting Trends and Techniques, published by the American Institute of Certified Public Accountants.

-Performance Concept as Developed

Via Lease Controversy

If leases are examined as executory contracts, or, in terms of generally accepted accounting principles for executory contracts, additional questions are raised concerning the nature of performance. It will probably be useful in subsequent analysis and discussion, to take the liberty of classifying all leases as either "operating" or "financial," as was done in Accounting Principles Board Opinion No. 7. Further, it will be useful to equate financial leases with
leases which are, in substance, installment purchases and thus, should be capitalized according to Accounting Principles Board Opinion No. 5, and to equate the operating lease with leases which are not, in substance, installment purchases.

The capitalization of leases is advocated on at least three different bases by several noted authorities. Myers incorporates the performance concept under executory contracts into his reasoning and conclusions with respect to leases. He is careful to note that in recognizing the financial lease in the balance sheet, he is recognizing the lease contract only to the extent performance has taken place. He considers that the lessor has fully performed in making the leased property available for use. The lessee, in turn, has acquired an asset in the form of the right to use of the property.12 On the other hand, Myers does not think the lessor has performed simply by making the leased asset available in the case of an operating type lease, since he

must continue to provide services, such as maintenance, insurance, property taxes, heat, light, and elevator service.\textsuperscript{13}

Arthur Andersen & Co. however, suggests that the profession go a bit further than capitalizing only the financial type lease:

\ldots because the similarity of the rights and obligations of the lessee under 'all' (emphasis added) leases for property and equipment, irrespective of period or purpose it follows that there is no logical basis except relative immateriality for omitting any of the lease rights and obligations from the balance sheet of the lessee. Thus, where in the aggregate the lease obligations and the related property rights would constitute amounts that were material in relation to the financial position of the lessee, they should be shown as assets and liabilities in the lessee's balance sheet.\textsuperscript{14}

As noted, Arthur Andersen & Co. takes the position that all leases should be capitalized because the lessee acquires a "valuable asset in the form of the agreed rights to use the leased property."\textsuperscript{15} Apparently, they see no

\textsuperscript{13}\textit{Ibid.}, p. 5.

\textsuperscript{14}Arthur Andersen & Co., \textit{Accounting and Reporting Problems of the Accounting Profession} (second edition; October, 1962), p. 28.

\textsuperscript{15}\textit{Ibid.}, p. 27.
distinction in the extent of performance under the financial versus operating type lease as does Myers.\(^\text{16}\)

In Opinion No. 5, only leases in which a material equity exists, i.e., those which are, in substance, installment purchases, should be reflected as assets and liabilities in financial statements of lessees. Leases which convey merely the right to use property, without an equity accruing to the lessee, are executory contracts, i.e., the lessor has not performed by delivery of the leased asset.\(^\text{17}\) In contrast, leases which are, in substance, installment purchases should be capitalized because a material equity has accrued to the lessee. It should be noted that lack of performance under an executory contract is used as the theoretical basis for arguing that the operating type lease should not be capitalized. On the other hand, this same theoretical basis is not explicitly used to support capitalization of the financial type lease. It seems evident that had the Accounting Principles Board attempted to support its decision not

\(^{16}\text{Ibid.}, \text{p. 30.}\)

\(^{17}\text{APB Opinion No. 5, "Reporting of Leases in Financial Statements of the Lessee," American Institute of Certified Public Accountants (September, 1964), p. 30.}\)
to capitalize some leases, on the basis that they are executory contracts, it would have been confronted with the knotty issue of determining just what constitutes performance under an executory contract. Such an approach would also seem to require a demonstration that (in spite of the fact that under all leases the leased property is always made completely available to the lessee) under some leases performance has been completed by delivery, while under others it has not.

The preceding comments on leases suggest that the performance concept, under present generally accepted accounting principles with respect to executory contracts, has not been utilized in any substantial way to support the recognition or non-recognition of leases as assets and liabilities. The various treatments suggested for leases do not seem to rest upon well-formulated, comprehensive concepts for dealing with executory contracts. Rather than consistently applying current generally accepted accounting principles for executory contracts to support or destroy the

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capitalization of lease contracts, various other principles have been employed in both official pronouncements and other current literature.

**Extension of Lease Principles to Other Executory Contracts**

Another important conceptual problem is raised if one attempts to extend the "theory of executory contracts" contained in the discussion of leases just presented. In the case of leases, Accounting Principles Board Opinion No. 5 allows a deviation from generally accepted accounting principles, with respect to executory contracts:

> On the other hand some lease agreements are essentially equivalent to installment purchases of property. In such cases the substance of the arrangement rather than the legal form should determine the accounting treatment . . . .

The principle stated here, that the "substance," rather than legal form of contracts should be controlling, has application to other types of executory contracts. For example, one recent article shows that long-term purchase contracts are being used to achieve the same purpose as a

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*Accounting Principles Board, op. cit., p. 30.*
bond issue, but which, according to current practice are not reflected in financial statements. The following example will serve to illustrate the point.

In 1957, Time Inc. and Crown Zellerbach Corporation jointly formed the St. Francisville Paper Company to build and operate a groundwood pulp and paper mill in St. Francisville, Louisiana. This operation is financed with an investment by both Time and Crown and by first mortgage bonds sold to outside investors. Time and Crown each own 50% of the stock and the investment of each company is about $7 million. The first mortgage bonds issued by St. Francisville amount to about $17 million. Time and Crown report their investment on a non-consolidated basis.

As security for the bonds, Time and Crown have executed long-term purchase contracts whereby each company is obligated to purchase paper produced during 50% of the total available operating time of the paper machines.

... these purchase contracts are generally in effect for a specified period ending not earlier than the maturity date of the bonds and the contracts are not subject to termination without the consent of the lenders. Also, the high credit companies (Time and Crown Zellerbach) waive any rights to claim damages or terminate the contract because of the borrower's (St. Francisville) default.21

The point to be noted is that recording the substance

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21 Ibid., p. 3.
of transactions would have extremely wide application not only to executory contracts, but to all accounting transactions, and that a principle such as this should be adopted cautiously. The substance of the contract described above is that Time and Crown Zellerbach have a firm obligation to make periodic payments to St. Francisville, which in no way are dependent upon additional performance by St. Francisville. Whether St. Francisville produces or not, the payments must be made to guarantee that St. Francisville will be able to service the $17 million debt.

In addition, this analysis points to the question of whether or not executory contracts, such as, purchase commitments are, or can be considered to be assets and liabilities in financial statements. The writers in the above article think purchase commitments are similar enough to debt to justify their capitalization.

Are Purchase Commitments Assets According to Generally Accepted Accounting Principles?

Consider long-term purchase commitments which are not recorded presumable because the supplier has not performed or delivered merchandise, and hence, no asset or liability
has been created. Generally accepted accounting principles allow the recording of losses on these contracts, according to Accounting Research Bulletin No. 43.

Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in financial statements.22

It is an unenviable position where one will consent to recognize losses on assets when he will not admit the existence of those assets in the same financial statements. Perhaps one can say that in the case of purchase commitments, as in the case of other forms of contractual commitments, the issue of performance was pushed into the background or ignored in favor of other bases of recording. This procedure can be tolerated if one admits the existence of an asset in the form of a contract right to be recorded, but then, innumerable contract rights would have to be capitalized. The procedure of recording losses on purchase commitments would seem to be more reasonable, if one admits the commitments are assets and liabilities in the form of contract rights and obligations--but then, innumerable other contract rights and

obligations would have to be recognized in a similar manner. 23

Possible Ways to View the Concept of Performance

A comprehensive statement has never been made regarding the concept of performance under executory contracts. It would seem that if this concept is to serve as a foundation for the accounting treatment of executory contract, it will require a more detailed study and analysis.

There are all sorts of questions which can be posed regarding this concept. For example, if one is inclined to agree that under the financial lease substantial performance has taken place, whereas, under the operating lease, substantial performance has not taken place, what is the extent of difference in performance? Professor Myers is the only writer who even attempts to answer this question. In his view, due to the fact that the additional services, such as maintenance, insurance and the like, have to be rendered on a continuing basis, substantial performance has not taken

23 For example, see Alfred Rappaport, "Lease Capitalization and the Transaction Concept," The Accounting Review (April, 1965), p. 375.
place, i.e., the contract is executory. This is an arguable point of view. Whether one is speaking of a building (under a financial type lease), or an automobile, computer or other equipment (under the operating type lease), delivery of the leased asset does seem to be a substantial part of performance, while the additional services can be of rather minor importance in many cases.

Consider another case. For example, it is not uncommon for the entire production of an oil or gas well for twenty years or thirty years or so, to be sold under purchase contracts at fixed prices, or prices determined by specified indices. In this type situation, the purchaser's pipe lines are attached to the well. The only additional performance required by the seller is that he turn on the valve to let the oil or gas flow. The only reason the purchaser does not use the entire production of the well in one period is probably because the oil is not needed. If the purchaser was in a position to need the entire production of the well in a single period, his demand would be met by a simple turn of the valve.

Examining the question further, it might be argued
that under a purchase commitment for say, manufactured goods, all inventory has not been delivered, and therefore is not available for use. Several points can be raised. First, perhaps the most significant aspect of performance is not the delivery of assets, but rather, that aspect which gives rise to assets and liabilities whether they be legal or economic, i.e., that aspect of performance which gives rise to the right of delivery, or obligation to discharge liabilities.

Secondly, one cannot use or derive all the economic benefits to be received under a long-term lease contract in the current period—only so much economic benefit can be had from the lease or only so much economic benefit can be drained from the property during any time period. Likewise, in the current period, a firm may not need all the inventory it is committed to purchase under a long-term contract. Thus, availability of the asset service beyond that needed for current operations, may not be necessary to receive, practically speaking, the full benefit of the asset during

24According to Accounting Principles Board Opinion No. 5, neither "availability for use" nor "right to use" alone can create assets and liabilities.
the current period. If performance is thought of as delivery of the economic service potentials (assets) of the contract, such performance need not be complete in order to receive the full benefit of the contract needed during the current period. Thus, the fact that the total economic service potentials purchased under a particular contract are not available for use during the current period, may not be a compelling reason for not capitalizing the contract.

A third point is that performance, in and of itself, does not give rise to assets. One can perform under a contract and if the result of that performance, or if what is received in exchange for that performance has no future economic value or service potential to the given party, no asset has ensued or has been acquired. At the same time, however, while performance need not necessarily produce an asset, perhaps an asset cannot be received without performance.

Performance is simply activity or inactivity in accordance with a contract which may give rise to rights (assets) in a legal sense, but not necessarily in an economic sense. Whether or not an asset results from performance depends upon the definition of an asset. This point is
treated in a later chapter.

The last point to be noted in this section is that the concept of performance, as most other concepts, has several dimensions. There are all sorts of qualifying adjectives which can be used—physical performance, economic performance, legal performance, substantial performance. Also, performance would even seem to have a time dimension. One might even attempt to apply a sort of critical event concept to performance. Accountants seem to have focused essentially on the legal aspects of performance, or at least one may infer that their operational definition is essentially legal.

The Major Problem

The concept of performance does not seem to lead to any broader purpose or objective. If this concept is to be used, it must be further explored and related to the objectives of accounting. Any accounting theory for executory contracts should directly relate to the function and purpose of accounting, rather than leading simply to a legal concept, wherein, extent of performance is a guide to achieving the objective of determination of damages to be awarded for breach of contract, and to settle contractual disputes, i.e.,
to determine the dollar amount of legal liability. Accountants should not conform their reporting function to such a purpose or report so as to facilitate such an objective. The major problem present in the current theory of executory contracts is the same as the problem present in major portions of current accounting theory. Bedford described it in this fashion:

The organized discipline does not present a uniform consistent pattern of thought throughout its theory. In fact, theoretical expressions that are contradictory and inconsistent are more typical of accounting theory than supporting and consistent utterances. Varying conditions, interests and beliefs have resulted in a number of variations in the theoretical conditions and environment from which each theory was developed.25

The preceding discussion of conceptual difficulties demonstrates that very important point that if used alone, the performance concept, as presently defined and understood, may be an inadequate theoretical basis for the treatment of executory contracts. Considering these difficulties and Bedford's comments above, it appears a broad approach is required. Executory contracts must be examined in light of

whether or not an executory contract represents a trans-
action in the technical accounting sense, and therefore, an
event which should be recorded. It must be determined
whether or not the signing of a contract prior to legal
performance gives rise to assets and liabilities, and whe-
ther or not such an event is relevant financial information
worthy of being reported.

Framework for Subsequent Discussion

On the basis of the preceding discussion, it might be
stated that generally accepted accounting principles, with
respect to leases and other executory contracts, have been
studied in a vacuum. The solution to the executory con-
tract problem lies in a determination of whether or not
rights and obligations arising under executory contracts
give rise to assets and liabilities. It is submitted that
whether such rights and obligations can be considered assets
and liabilities, respectively, is a definitional problem,
i.e., it depends upon the definition of assets and liaabili-
ties. The conception of assets and liabilities on the other
hand, is, or should be, dependent upon what the accountant
is attempting to achieve with his financial statement
presentations.

What accountants are attempting to achieve with financial statements is based upon the overall objectives of accounting, and the principles deemed necessary to accomplish those objectives. Any well formulated, long-standing solution must fit into this broad theoretical framework. Thus, the relationship of executory contracts to the objectives of accounting and the means or principles used to accomplish those objectives, will be the subject matter of the next two chapters.
CHAPTER IV

OBJECTIVES OF FINANCIAL REPORTING MODEL

Chapters IV and V consist of a discussion of a financial reporting model, which can be used to accommodate the needs of users of published financial statements. The model presented in these two chapters is basically a combination of the 1966 AAA Statement of Basic Accounting Theory and Accounting Research Study No. 3 by Sprouse and Moonitz. ¹ The AAA Statement supplies the overall objectives of accounting while, Accounting Research Study No. 3 supplies the operational definitions or concepts needed to achieve these objectives. These two statements are modified to form an integrated financial reporting model designed to include

executory contracts. This chapter can be viewed as a presentation of the objectives of accounting and financial reporting, along with a discussion of several executory contracts which show their relationship to these objectives. Chapter V supplies the remaining elements of the model—the theoretical means (operational definitions of assets, liabilities and the like) which should be used to accomplish these objectives. As integrated in the next two chapters, the above-mentioned statements constitute a theoretical framework or model which may be utilized in satisfying, or coping with the executory contracts issue.

Objectives of Accounting

A sound approach to theory requires that the objectives of accounting must first be defined. Devine agrees wholeheartedly that when any attempt is made to construct a theoretical system for any function, especially a service function, it is necessary to establish the purposes and objectives of that function. However, he further notes

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that objectives and purposes "shift through time, but for any period they must be specified." Such specification yields a logical framework which permits one to "investigate and conduct research in terms of carefully constructed objectives." Thus, before determining the proper treatment which should be accorded executory contracts, the objectives of accounting must first be established.

When the generally accepted accounting principles currently governing the treatment of executory contracts were first established, perhaps, in terms of the objectives of accounting conceived at that time, reporting of executory contracts was not necessary to accomplish these objectives. It will be recalled from Chapter II that the current theory of executory contracts was derived almost totally from the treatment suggested for purchase commitments and leases by such writers as Canning, Sprague, Kester and Montgomery during the 1920's and 1930's.

Executory contracts may not have been within the domain of accounting in the past, but such may no longer be the case.

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3Ibid.

4Ibid.
Rather, there seems to be nothing inherent which dictates that they be excluded from consideration in the accounting discipline. In addition, it might be said that the previous chapters suggest there is a pressing need to consider the place of executory contracts in the accounting information system. In this respect, it should be noted that one of the primary concerns of this study is to establish the place of executory contracts in financial accounting. Therefore, when the objectives of accounting in general are sought, it should be borne in mind that the objectives of financial accounting (as opposed to managerial accounting, cost accounting, auditing, and the like) are being sought.

The Nature of Accounting

Perhaps the broadest and most recent approach to accounting was that taken by the Committee to Prepare a Statement of Basic Accounting Theory of the American Accounting Association:

The committee defines accounting as the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.5

One committee member subsequently interpreted this definition to mean that the accounting discipline is "essentially, an information system--a process for developing and transmitting information."° Accounting is conceived of "as a part of the general information system of an operative entity and as part of a basic field bounded by the concept of information." 7 This casts accounting in a newer and broader role which dictates a broader theoretical structure which will enable accounting to "measure and communicate data on past, present and prospective activities of all types in order to improve control methods and decision-making at all levels."8

The AAA Statement takes a deductive approach that is in direct contrast to both the approach of Paton and Littleton, who sought the "weaving together (of) current practices into a coherent whole, and Grady's method of inventorying practices and then justifying them."9 This deductive

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7 Ibid., p. 83.
8 Ibid., p. 84.
The preceding description of accounting reflects the recent idea that accounting encompasses more than what might be called the traditional areas of accounting (i.e., financial, managerial, auditing, and so forth). The accounting discipline should be expanded to take on the numerous social objectives of the modern corporation. If the corporation is recognized as having these social obligations or objectives, such recognition dictates that the informational needs required to accomplish these objectives must be assumed by accounting. In other words, since the modern corporation is conceived of as having multiple and diversified goals, in addition to income generation, accounting must respond, in terms of increased information, to this expansion of goals. Such additional goals include: stabilization of employment,
advances in productivity, contributions to general economic growth, innovation, and enlargement of public services. The expanded theoretical and informational frameworks required of accounting to accommodate these social objectives are beginning to appear in the literature. However, this study is not interested directly in this expanded social framework of accounting. These expanded social objectives are mentioned only because of the potential importance of executory contract data in accomplishing these objectives by expanding the range of data reported. Rather, the areas of concern are limited to those of financial accounting in this study. In short, no attempt is made to relate executory contracts to the expanded social concept of accounting.

**Objective of Financial Accounting or Financial Reporting**

Several writers have charged that, in spite of the fact that financial accounting or financial reporting is generally recognized as providing a service, little attention

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or research has been directed to investigating what the nature of this service is, or should be. In short, what are or what should be the objectives of financial reporting. According to Rappaport, attempts to answer this question in the accounting literature have two primary deficiencies:

(1) they are presented in such vague terms that little or no direction is offered to the further development of a system of theory or (2) they are presented in more specific terms, but the underlying criteria and rationale for the stated objectives are not apparent.\(^{11}\)

Furthermore, Rappaport points out that the urgent need to establish these objectives is demonstrated by the current research attempts of the AICPA and the accounting profession as a whole, to formulate acceptable statements of accounting postulates and principles.\(^{12}\)

Recent research has begun, however, to lay the foundation for a broader and more explicit presentation of financial reporting objectives. In fact, Rappaport is helpful in bridging the gap between the social objective of


\(^{12}\)Ibid., p. 962.
accounting mentioned earlier and the objective of financial reporting. He proceeds by examining the "relationship between the corporation and the fundamental ideals or values of society" which should afford "the accounting profession a framework for selecting both an appropriate audience and an improved concept of information." Accordingly, four basic objectives for external reporting are suggested by the examination of social values:

(1) The managements of large business corporations have a reporting obligation to those segments of society affected by their decisions, i.e. investors, employees, consumers, suppliers, local communities, and the public at large.

(2) Those groups with a legitimate interest in the corporation should be provided with information essential to arriving at rational judgements concerning the equitable sharing of corporate benefits.

(3) In the interest of economic progress, those groups which are responsible for allocating resources in our economy should be provided with information which will promote efficient allocation.

(4) In the interest of sustaining our basic values, information which is likely to influence socially desirable behavior and discourage undesirable behavior should be reported; e.g. calling attention to monopoly profits to preserve pluralism in the industrial sector of our economy.13

13Ibid., p. 953.
14Ibid., p. 958.
As mentioned by its author, the above is only one particular formulation of financial reporting objectives. Other alternative interpretations should prompt an authoritative statement by the AICPA or AAA on corporate reporting objectives.

Although the preceding is excellent and a refreshing discussion of the objectives of accounting, it is largely unexplored to date. For that reason, a more traditional framework of objectives is adopted in this paper. Hendrikson puts forth these objectives of financial accounting as well as anyone to date:

1. Financial accounting should provide the relevant information necessary for the making of economic decisions by persons or entities outside of the reporting enterprise or entity. These interested parties include primarily stockholders, other investors, and creditors: secondarily, they include employees, customers and the public. The government is also an interested party, but generally it does not rely only on the published financial statements; it requires that the usual statements be supplemented by special reports for specified purposes.

2. The information presented should be directed toward aiding in making the following types of decisions: (a) investment decisions including the purchase and sale of stock or other ownership shares; (b) decisions requiring an evaluation of the efficiency of management by the stockholders and others; (c) financial decisions requiring an estimate of the
ability of the enterprise to pay current or future debts as they mature; and (d) decisions regarding the fairness of resource allocation.

3. For use in making the above decisions, accounting should provide the relevant information that can be expressed in financial terms and other information that is necessary for a proper interpretation of the financial data. The objective of 'fairness' is relevant in this presentation.

These objectives answer the questions (1) to whom is financial accounting directed; (2) for what purposes are accounting statements prepared; and (3) what types of information should be included in accounting reports.15

**Users Must Be Identified**

The objectives of financial reporting emphasize providing information relevant to the user. If broad general statements are permitted, it might be said that the basic objective of financial reporting is to communicate to the interested user, those elements of economic or financial information vital to his purpose or necessary to his decision. To recognize the needs of the user as being the controlling factor in financial reporting (and there seems to be a consensus that this is the approach which

should be taken) is one thing, but to identify the users and
to determine their informational needs may be quite another
matter. Both Rappaport and Hendrikson have shown apprecia-
tion for this problem and have attempted to specify users
and their needs. Moonitz, recognizing the potential of a
user-oriented approach, warns that:

... anyone who stresses 'usefulness' as a cri-
terion, in accounting or elsewhere, must answer
the two pointed question--useful to whom and for
what purpose? And herein lies the danger. We
could easily be trapped into defining accounting
and formulating its postulates, principles and
rules in terms of some special interest, such as
the business community, or the regulatory agencies,
or investors, or tax collectors.16

It is not difficult to determine who uses external financial
reports, since almost every source which discusses the objec-
tive of financial reporting, lists the users. For example,
the following is as good a list as can be found in the
current literature: present and potential investors, credi-
tors, employees, stock exchanges, governmental units, cus-
tomers, security analysts, trade association, credit rating
bureaus, trade union officers, regulatory commissions, tax

16Maurice Moonitz, The Basic Postulates of Accounting,
Accounting Research Study No. 1 (New York: American Insti-
authorities, and representatives of all these users.17

Needs of Users

Once users have been identified, the crucial questions are: what decisions do these various parties make, and what information will best enable them to make these decisions? The needs of the user should be the controlling factor but all users do not need the same information and accounting cannot report all information.18 As some have pointed out, accountants have not sought to satisfy specific purposes or needs of users. Rather, various users (stockholders, creditors, employees, and so forth) have been offered general purpose statements designed to satisfy very generalized needs.19

Devine offers three alternatives to the problem of determining what information should be presented in the


external reports. First, a "smorgasbord of information" could be presented which would allow the reader to make his own selection of relevant data. Second, the accountant could "search for and weigh recurring patterns" of needs, and employ the results as guides for selecting and reporting information. A third alternative is to embark upon an educational program designed to educate users to the use of information in different decision contexts. There seems to be a consensus that the profession will proceed according to the second alternative. Devine seems to favor the second alternative, while others comment that this is, indeed, the approach the profession is currently taking.

Also, Vatter indicates that alternatives one and three might not be very desirable. He charges that few people who receive published financial reports are well enough informed to be able to select relevant information

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20 Devine, op. cit., p. 19.

21 Solomons, op. cit., p. 62.

and that attempts to educate users will be very difficult. It seems that readers do not even understand what might be considered basic data. Vatter cites a study sponsored by the Financial Executives Research Foundation which indicates that 90% of the stockholders were unable to give even a partial definition of some elementary terms (e.g., Funded Debt, Cash-flow, Paid-in-surplus). More than half could not define such terms as Working Capital, Depreciation, Subsidiary, or Assets. Thus, it seems the accountant is in the position of specifying what information is useful to users.

The AAA Statement has put forth standards by which to evaluate potential accounting information, or rules for judging the usefulness of accounting information. In the view of the authors of the AAA Statement, the utility of accounting information "lies in its ability to reduce uncertainty about the actual state of affairs of concern to the user." Adherence to the standards of relevance, verifiability,

23AAA Statement, op. cit., p. 4, supports these conclusions.

24Vatter, op. cit., p. 78.

freedom from bias, and quantifiability should substantially reduce this uncertainty, and thereby serve or "constitute a basis for inclusion or exclusion of data as accounting information." These standards are to be the basis for inclusion or exclusion of executory contract data. Executory contract data which does not meet these standards are unacceptable accounting information. In contrast, executory contract data which meet these criteria must be considered for reporting.

**Executory Contract Data Meet Standards**

In a chapter on "Accounting Information for External Users," the Committee to Prepare a Statement of Basic Accounting Theory takes the point of view that executory contracts present one of the currently troublesome problems in accounting, and proceeds to make some rather specific recommendation. It is apparent in the following quotation, that at least some executory contracts meet the standards for accounting information to the satisfaction of the authors of the AAA Statement:

II. Executory contracts. Accounting at present recognizes most market transactions involving goods, services, or money as one of the elements

\[26\text{Ibid.}\]
of the transaction. Present accounting also generally ignores, except in special circumstances, transactions involving an exchange of a promise for a promise. Leases, purchase commitments, executive and other labor contracts are generally denied recognition until the services or goods specified in the contract are either used, delivered, or paid for.

Many of these contracts meet the standards of verifiability, freedom from bias, and quantifiability at least as well as other reported events.

Generally a contract specifies amounts that allow verification and quantification. For contracts of long duration, a valuation problem in terms of present values exists, but this problem is no greater than in other problems involving accounting judgment, such as estimation of collectibility of receivables. These contracts also do not appear to contain any biases. The only reason for exclusion, where the other standards are met, must be based on relevance. The committee feels that short-term contracts or contracts that are essentially renewed periodically in equal amounts may justifiably be ignored on the grounds that information about such commitments does not possess sufficient relevance to justify inclusion in accounting reports. Perhaps a better way of stating the above conclusions is that in such cases deferring recognition of such events until the services or goods are used or delivered does not do much harm. This, however, cannot be said about contracts extending over long periods that are material or that are not repetitive. Information about such contracts is clearly relevant to a host of decisions involving stewardship, changes in management, credit extension, and investment decisions. Recording of these events would also result in greater uniformity of reporting essentially similar events where the only difference lies in the form of obligation assumed. Therefore, the committee recommends the reporting of all long-term leases, material and
non-repetitive purchase commitments, pension plans, and executive compensation contracts including stock options or deferred payments and the like in dollar terms in the regular framework of the statements.

This does not imply that all useful accounting information must be incorporated in the double-entry structure; at the same time, maximizing what is recorded in that system is a useful means of avoiding errors of omission in reporting of relevant information.27

This rather unique statement by the AAA committee on executory contracts represents a significant departure from the generally accepted accounting principles discussed in the earlier chapters. Two points in particular bear very heavily on our present discussion. First, executory contracts, by definition, involve events which have not taken place, and attempts to reflect such future transactions in published financial statements are, in reality, attempts to incorporate predictive events in those statements. To what extent is this a valid approach or objective which accounting should undertake? To rephrase the question, should expectations or predictions be incorporated in published financial statements? Second, as specified by the committee,

27Ibid., pp. 32-33.
relevance is the primary criterion for judging the usefulness of information on executory contracts. In what ways, then, is information on executory contracts relevant to users' decisions, and how can this relevancy be demonstrated? These two points will be discussed in that order in the following paragraphs.

Incorporating Expectations in Financial Statements

The stewardship function has always held an important place in determining or assessing the effectiveness of management. It is often claimed that accounting is essentially historical in nature. But probably what is meant by this statement is that accounting seeks to measure past events or past transactions. However, this interpretation in no way denies the orientation of the accountant to the future. History often has little value except as a guide for the future. A major role of accounting is admittedly, to perform the stewardship function, or to report on past performance. However, the primary reason for such reporting is to give some guide to reducing uncertainty about the future. The accountant has always recognized the need to supply statement readers with information which will help
them to predict the future. Furthermore, this recognition of information for the future is not a recent objective of accountants. Such a conclusion is explicit in the list of major uses of financial accounts or financial accounting listed by George O. May:

(1) A report of stewardship
(2) A basis for fiscal policy
(3) A device to determine the legality of dividends
(4) A guide to wise dividend action
(5) A basis for the granting of credit
(6) Information for prospective investors in an enterprise
(7) A guide for price or rate regulation
(8) An aid of Government supervision
(9) A basis for price or rate regulation
(10) A basis for taxation

With the exception of numbers 1, 3 and possibly 10, in the above list, it can be said that all of these uses or purposes involve a future decision, i.e., the reason for collection of the information is to provide a basis for a future decision. In particular, the accountant's measure of income provides a basis for future decisions. In fact, income is essentially a predictive device as noted by Hendrikson:

However, most of the decisions of creditors and investors, including the stockholders of large corporations, require a prediction of the future flow of income. Historical income is water over the dam; the important decisions regarding the purchase or sale of stock or bonds of the firm or the making of a loan to the firm require expectations regarding the future.  

Certainly, two of the primary users of published corporate reports are creditors and investors. Their primary need, in terms of information, is for data which will enable them to formulate sound expectations regarding the future performance of the given company.

Whether he cares to admit it or not, the accountant seeks to incorporate expectations or predictions into both the income statement and balance sheet. The currently accepted concept of assets as expected future economic benefits, or as future service potentials, is a reflection of this tendency to include expectations.  

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31 For a discussion of this concept, see American Accounting Association Committee on Concepts and Standards, Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 3.
in connection with these definitions of assets, is that they represent attempts to incorporate a quantification of future expectations into the balance sheet, and rightly so, since the relevant concept of assets is one that will enable readers to have some basis for the future decisions.

Additional evidence, to support the contention that recording of expectations is in the domain of the accountant, is supplied by noting the recent trend toward inclusion of probability estimates in financial statements. In effect, these measures are attempts to include expectations or predictions in financial statements. It should also be noted that the accountant has a history of recording expectations. For example, the valuation of marketable securities or inventories at market value is really the recording of an expected value. The valuation of accounts receivable by use of an allowance for uncollectibles, is an attempt to state receivables at their net realizable value or their expected value.

In summary, the incorporation of expectations into

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financial statements, or attempts to achieve some measure of predictability in published financial statements, is certainly not new in accounting. This orientation to the future has been summed up very well in the following quotation from the AAA Statement:

Although accounting has often been thought of as essentially historical in nature, it is important to recognize that emphasis upon those accounting techniques that deal with future plans and expectations has been increasing, and that this trend may be expected to continue. Furthermore, the historical record is kept, as all history studied, for its lessons to be used as a guide to the future, this is another way of saying that the informational demands upon accounting are the requirements of the decisions in which it is used, and that these almost always have an orientation to the future.  

In connection with reporting to external parties, the same AAA Statement reports that "most decisions based on accounting information involve some kind of prediction." Some examples are future earnings forecasts, repayment of debts, and anticipated managerial effectiveness.  

On the basis of the preceding discussion, it might be concluded that accountants recognize the need to provide

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33 AAA Statement, op. cit., pp. 5-6.

34 Ibid., p. 19.
information to predict the future, but are very reluctant to incorporate predictive type data, as such, into the balance sheet and income statement. Accountants have always recorded expectations, particularly when expense and revenue accruals were involved. The problem at hand seems to be one of how far accountants are willing to go in recording expectations in published financial statements, i.e., how much or what degree of predictability should be, or is, tolerated by accountants?

Predictability or expectations being included in financial statements seems to be a direct function of the accountant's concept of objectivity. The most important reason for failing to record expectations has been the difficulty of measuring objectively, or achieving a satisfactory degree of objectivity about expectations or predictions. It has been shown that the present concept of objectivity is, at best, a vague and ill-defined concept. The concept must be


expanded to cope with advances in measurement techniques and new informational requirements of the users of financial statements. These informational requirements, it is submitted, include data on executory contracts, i.e., such data should be included in published financial statements, as will be shown in later paragraphs.

Relevance to Users' Decision Models

The definition of "accounting as the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information" points directly to the notion of relevance. Whether or not information on executory contracts is relevant must be related to the users' decision model. But the problem lies precisely in this relationship. While "the committee advocates the reporting of all information that is believed to be relevant to the judgments and decisions of any substantial group of users" establishing relevance becomes a


different and difficult matter. It can be argued at some levels, that the ability of the accounting function to transmit information is limited. Accounting obviously cannot provide all information. However valid this argument, it is not relevant to the present level of analysis. Reporting of executory contract data could hardly be thought of as straining the reporting capacity (in terms of quantity of data) of accounting as an information system. As Sterling correctly points out, accounting should be concerned primarily with the value of the data or information.

Assessing the value of data to users requires a look at their various decision models to determine informational needs. Such a task presents several difficulties to a study on executory contracts. First, as was pointed out earlier, most users do not know their needs, or are themselves not familiar with their own decision models. Second, the informational needs of users are heavily influenced by the data that are transmitted. As Sterling has noted:


He (the accountant) cannot be neutral because his transmissions will be a major factor in determining what the future generations consider relevant. The very definition of information is dependent upon previous information; it is a cause of desires in an on-going process as well as an effect of the present desires.

For this reason I am suspicious of the simplistic idea of polling the receivers. In the present state of accounting, I have no doubt that a poll would improve our current reporting but it does not even approach a satisfactory solution.41

Accounting has not developed to the stage where it has successfully defined the decision models of external users of financial statements. The possible decision models of external users, having wide varieties of purposes, are too numerous to even list. In some of these decisions executory contract data will be relevant; in others not relevant.

Again, Sterling has captured the crux of the problem:

The major problem of accounting is to develop a general information system. By this I mean a system that supplies relevant data to both specific and unspecific decision models. The point can best be illustrated by the committee's programmed-unprogrammed matrix (p. 44). If we have a production process with a variable material mix, there is a unique solution by a linear programming model. The capital budgeting model will provide a yes-no solution to simple investment problems. These models clearly specify the relevant data . . . . The

41Ibid., pp. 107-108.
relevance problem is trivial in such cases . . . .

It is in the unprogrammed areas that difficulties are encountered. There the decision models are not well defined; indeed the problems are often unknown. It is this area of internal reporting that intersects with external reporting. External reporting also has programmed data requirements, e.g., the revenue code specifies the relevant data in tedious detail and thus there is no relevance problem. The difficult task is to make measurements that are relevant to the unprogrammed decisions. Since the problems which give rise to unprogrammed decisions are likely to change over time and since the perceived problems are (partially at least) a function of the information received, it is unlikely that a final solution can ever be found.42

Since the formulation of decision models for outside users' (even for major users, such as creditors and investors) is a mammoth undertaking, this task of formulation certainly cannot be undertaken in the present study. However, the needs of external users in their respective decision models is the key to the treatment which should be accorded executory contracts in published financial statements. As a result, one is forced to relate executory contracts to the general information system mentioned by Sterling. To the extent that future research demonstrates that executory contract data is not relevant to the decision models of

42Ibid., p. 107.
particular external users, any subsequent recommended treatment of executory contracts may not be applicable. Such a limitation does not appear to be very serious, however, since executory contracts can be shown to be relevant to the generally accepted or conventional decisions which users of published financial statements must make. A number of specific examples are discussed at the end of this chapter to support this conclusion. It is important that this limitation be clearly understood. In this paper, the traditional, existing, and somewhat general decision models of external users are accepted, and no attempt is made to prove or disprove these models, nor to derive new and different models.

Information Required by External Users

Although decision models for each and every external user of accounting data cannot be constructed, it is possible to specify, in a general way, some of the decisions which these users face, and to set forth their informational needs. For many of these decisions and needs, executory contract data are crucial. Speaking first of stockholders and potential stockholders, there are four decisions which must
be made. Existing stockholders must decide to maintain their investments or terminate them. Potential investors must consider investing or not investing. In addition, an investor may occasionally face the problem of holding stock, or converting it into some form of security. The factors which will bear on these decisions will be past and projected earnings of the firm, as well as the firm's ability to pay dividends and expand, through internal and external generation of funds. The predicted effectiveness of management will usually be given considerable weight. Obviously, ability to predict future costs and revenues will be crucial to earnings predictions.

Creditors and prospective creditors must determine the firm's ability to meet annual interest payments, as well as any sinking fund requirements and repayments at maturity. Other creditors, such as banks and suppliers, must decide on lines of credit, whether to increase or decrease loans, the types of security which should be required, and whether or not the firm's plans for growth are feasible.

Customers are, of course, primarily concerned with the company's ability to produce the desired quality and quantity of a product at reasonable costs. They must
determine whether or not the company can service, replace and develop equipment. As pointed out by the AAA Statement,

... in those situations where customers contract to buy major amounts of products or services over long periods of time, their relationship takes on the characteristics of that of a creditor.43

Other external users' needs must be met by the same general type information. As noted previously, these users include employees, governmental units, stock exchanges, financial and statistical information services, and the like.

By employing ratio analyses, trend analyses and similar techniques, these users evidence an interest in predicting or in eliminating some of the uncertainty associated with the following general measurements:44

(1) Costs, Revenues and Earnings
(2) Dividends and Market Prices of Shares
(3) Financial Position
(4) Liquidity and Debt-Paying Ability
(5) Growth

43AAA Statement, op. cit., pp. 21-22.
44Ibid., pp. 23-25.
(6) Fund Flows
(7) Effectiveness of Management

All the above information is required, precisely because the particular user is involved in decisions. Investors, creditors and others must not only obtain this information for a given company, but the same information on a comparable basis must be available for other companies. Executory contract data becomes particularly relevant in this regard since it: (1) reduces some of the uncertainty in the above measurements, and (2) because executory contracts are often substituted for asset ownership (e.g., leasing versus outright ownership of assets, and use of purchase contracts instead of carrying inventory). These two points will be further illustrated and discussed in the next section.

Relevance of Executory Contracts--

Some Practical Examples

Almost without exception, the reporting of executory contract data is relevant to users as an aid in predicting, forecasting, or if one prefers, understanding, the future course of business for given corporations. This general
conclusion is supported in the subsequent discussion, which consists of an examination of the influence, or potential influence on investors' and creditors' decisions, of reporting a few types of executory contracts. Unfortunately, it is not possible to report on every type and variety of executory contract. Hopefully, future research efforts will be directed toward investigating, in more detail, other specific types of contracts, to which the principles or alternatives examined in this study, should be applicable.

Leases

Leasing is being used in some form by almost all large companies, and accounting and reporting for such executory contracts have been one of the major problems facing the accounting profession for the past several years. One writer reports that the first important sale and leaseback agreement was executed in 1936, by Safeway Stores. Since then, Safeway has increased its use of the lease, and, in its

1960 annual report, the company reported 2904 property leases, with maximum annual rentals of approximately $43 million. In 1966, although Safeway's total number of leases had declined to 2503, the minimum annual rentals on these leases had increased by some $18 million to a total of $61 million. Sears Roebuck & Company is another famed user of the sale-leaseback transaction. In 1946, Sears sold some Wisconsin stores to the Northeast Mutual Insurance Company, and subsequently leased them back. In its current annual report, Sears discloses minimum fixed annual rentals of $24 million. Fruehauf trailers, service stations, Greyhound bus terminals, Crucible Steel warehouses, new plants for the Continental Can Company, restaurants for Howard Johnson franchises, a wide variety of trucks, auto fleets and machinery are among the types of property commonly involved in the financial type lease transaction.\textsuperscript{46}

Investors, particularly institutional investors, are beginning to attach great weight to leases. The usefulness of information on leases is well documented in a study

conducted by Vancil and Anthony. In a rather extensive survey of financial analysts in major financial institutions in the United States and Canada (insurance companies, commercial banks, investment bankers, trustees of pension funds and college endowments, credit and bond-rating services), some 256 analysts responded to the questionnaire designed to determine how financial analysts treated lease contracts. In analyzing financial statements, 77% of the respondents capitalize lease payments, treat them as fixed charges, or follow both procedures. Eighty-one per cent of the respondents regard long-term lease obligations as comparable to debt.

If lease contracts are capitalized, the result is a tremendous increase in assets and corresponding liabilities. Even though capitalization procedures are illustrated in Chapter VI, an extreme example might be used here to demonstrate their effect. For example, Safeway Stores' total assets ($640,673,000) would nearly double (liabilities would increase by an equal amount) if their outstanding leases were

discounted at 6% and capitalized, as of December 31, 1966. Some indication of the extent of disclosure of long-term leases by lessees can be obtained by examining the following table.

**TABLE I**

**DISCLOSURE OF LEASES**

<table>
<thead>
<tr>
<th>Year</th>
<th>Co.'s referring to, or indicating leases</th>
<th>As a % of 600 Co.'s surveyed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>78</td>
<td>14.9</td>
</tr>
<tr>
<td>1955</td>
<td>214</td>
<td>35.7</td>
</tr>
<tr>
<td>1960</td>
<td>223</td>
<td>37.2</td>
</tr>
<tr>
<td>1966</td>
<td>292</td>
<td>48.6</td>
</tr>
</tbody>
</table>

Source: Accounting Trends and Techniques, 5th, 10th, 15th and 21st editions (New York: American Institute of Certified Public Accountants).

An examination of the statements of lessees for 1950 reveals that 78, or 14.9%, of the 600 companies surveyed indicated or made reference to long-term leases, with varying degrees of disclosure, in their annual reports. The above table reflects that these figures increased to 292, or 48.6%, of the 600 companies reporting in 1966. Of these 292 companies, 26 reported leases which were treated as purchases.
of property, or as sale-and-leaseback transactions. A sub-
stantial number, but not all of these 26 companies, capita-
lized the leases as assets and as liabilities. The exact
number of companies that followed capitalization procedures
is not available from the data given in Accounting Trends and
Techniques. The other 266 companies usually disclosed the
information in the footnotes to financial statements.

In addition, Professor Myers has also set out in
detail some of the information required by investors. He
indicates that a significant number of ratios, which reflect
the ability of the corporation to pay its debts, are affected
when lease payments are considered to be debt and long-term,
financial leases are capitalized in financial statements.
Among the ratios affected are: times-interest earned, debt
to total capitalization, debt to equity, debt to net plant,
working capital to plant, and plant to sales. Myers also
indicates that throughout the course of his study, all pro-
fessional analysts with whom he had contact "felt a strong

48 John H. Myers, Reporting of Leases in Financial
Statements, Accounting Research Study No. 4 (New York:
American Institute of Certified Public Accountants, 1962),
pp. 16-18.
need to include lease obligations in a cash-flow analysis." 49 Myers also notes that these analysts "want to know (on a year-by-year basis for at least the next few years) the amount of the cash outlay required under existing contracts, be they bond, lease or other." 50 In addition, investors demand all other sorts of information on lease contracts, ranging from options at maturity and default provisions, to restrictions against further leasing or debt.

Clearly, information on lease contracts is having a significant influence on the decisions of investors. In fact, users of published reports, including corporate managements, commonly capitalize leases to improve key financial ratios. 51 The informational value of lease contracts can hardly be disputed. The misleading and erroneous conclusions, which result from their omission as assets and liabilities in published financial statements, is well known and has been

49 Ibid., p. 18.
50 Ibid.
adequately discussed and presented in the literature and does not need to be presented again here. Indeed, footnote disclosure of leases has been inadequate even though it has increased in recent years.

**Purchase Contracts**

Compared with reporting of leases which is criticized as inadequate, the reporting of other types of executory contracts is very scant. Purchase commitments are a type of executory contract whose financial impact may be just as significant to investors' and creditors' decisions as are lease contracts. The financial reporting of purchase commitments is, at best, meager. In fact, the 1966 edition of *Accounting Trends and Techniques* shows that, of the 600 companies surveyed, the following were the results for three comparable years:

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52 See for example Donald R. Gant, "Illusion in Lease Financing," *Harvard Business Review* (March-April, 1959), pp. 121-42. A very complete description of the financial impact of almost all aspects of leases is contained in a series of six articles published in the *Harvard Business Review* from 1955 to 1963. These articles are available in reprint form under the title of "Leasing Series."
TABLE II

DISCLOSURE OF PURCHASE COMMITMENTS

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Companies Referring to Purchase Commitments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>38</td>
</tr>
<tr>
<td>1960</td>
<td>22</td>
</tr>
<tr>
<td>1955</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Accounting Trends and Techniques, 10th, 15th and 21st editions (New York: American Institute of Certified Public Accountants).

The above companies, indicating the existence of purchase commitments, customarily disclosed this information in notes to financial statements or in the president's letter. It is obvious, from the above statistics, that most companies fail to give any information on purchase commitments in their annual reports. In addition, the financial impact of purchase contracts may require that they be capitalized as assets and liabilities. Footnote disclosure, even if utilized, may not be sufficient. It can be seen in the following examples, that to omit purchase commitments from asset and liability totals, may be to omit them from conventional financial statement analysis.
In the case of the classic purchase agreement between the Tennessee Valley Authority and Peabody Coal Company, assume for purposes of discussion that Tennessee Valley Authority is a private corporation. Tennessee Valley Authority has invested $100,000,000 in a steam-electric generating plant, on the strength of a contract with Peabody to supply 65,000,000 tons of coal, worth $191,750,000 over a period of 17 years, from a nearby mine. TVA's basic reason for locating the plant next to the Peabody mine is the favorable purchase commitment negotiated for the coal. The cost of the coal is only $2.95 a ton, one fourth less than TVA pays on the average for coal for its other steam plants. The contract obviously has some provision for price escalation because of its long duration, but the escalation clauses are also restrictive. Clearly, the information on such a contract is relevant. The value of the steam generating plant may not be the same with, as without, the favorable purchase commitment. Perhaps it can be argued that the contract has no value, since it may be possible to purchase the

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same raw materials at the same price in the ordinary market, as under the contract. However, if such were the case, the contracting firm would not have entered into the contract in the first place, unless it did so erroneously. The more logical presumption is that the same raw materials were not available in the ordinary market place, which in turn made it necessary for the firm to enter into the purchase agreement.

The knowledge of similar contracts for the purchase of other raw materials, such as gas, oil, timber and the like, enables the interested investor or creditor to: (1) obtain better predictions of future costs and therefore, future profits, (2) obtain better predictions of future cash flows and cash requirements, and (3) improve his evaluation of the effectiveness or success of management in negotiating such contracts. Furthermore, this type contract, if included among the assets and liabilities, may improve financial ratios and measurements.

Another type of commitment, which is becoming more common, is the "take or pay" type contract between a purchaser and a wholly or partially owned supplier. Examples of this type contract are discussed in Chapter III. A
contract of this sort is reported by Interlake Steel Corporation in its 1966 annual report. Interlake reports, in notes to its financial statements, that it has interests in various ore mining and pelletizing projects. The Company is required to take its ownership proportion of the pellets and concentrates produced, for which it is, in turn, committed to pay its proportionate share of the costs of operating these projects, either directly, or as part of the price of the product purchased. The minimum amount payable annually by Interlake is $2,250,000, for approximately 20 years. These minimum payments must be made, regardless of the quantity of ore received from these suppliers. In other words, these annual payments are fixed obligations. Their similarity to debt payments is obvious and their financial impact identical in terms of demands upon the cash and other resources of the company. The duration of the contract is known, its annual cost, as well as its aggregate cost, are known. Equally important, however, is the fact that the contract assures Interlake of an available supply of raw materials. Clearly, the contract represents debt and probably should be capitalized as such. Although not specifically noted by Interlake, contracts of this type, which specify minimum
annual payments, are often used as security for long-term debt. In effect, these contracts achieve the same general purpose as a bond issue, but they are reflected in footnotes rather than in the financial statements or accounts.

This same type contract is used to purchase raw material, capital equipment, electric power, and to finance such things as ships and pipelines. The seller uses the agreement as security for debt issues by obligating the purchaser, under the purchase contract, to make annual payments in an amount sufficient to cover debt service. Thus, the purchaser has more than a mere contingent liability. If the purchaser owns stock in the borrower (seller under the purchase contract), the stock investment is usually carried at cost on an unconsolidated basis. Under this treatment, the debt is omitted from the purchaser's balance sheet and

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55 Burns, Jaedicke and Sangster, op. cit., p. 5.
the fixed costs in connection with the purchase contract are omitted. These elements, in turn, are omitted from all types of financial analysis and ratio analysis. Also, the investors and creditors of the purchasing firm are not receiving a "true picture of the assets, debt and fixed charges," when such commitments are not capitalized in the purchaser's balance sheet and the accompanying fixed charges are not reported in his income statement.

Another class of purchase commitments involves purchases and sales of merchandise inventory items. For example, Sears Roebuck and Company, in the "financial review" section of their 1966 annual report, lists merchandise on order and in transit amounting to $1.4 billion, as of year end. Inventory was $1.048 billion at the same date. The other parties to these contracts correspondingly have a backlog of unfilled orders. These contracts, both as purchase commitments and as backlogs of orders, can be very relevant financial information. On a comparative basis, these figures provide an indication of expected sales volume and volume of purchases. Also, they may give some indication of the

\[56\text{Ibid.}, \ p. \ 4.\]
efficiency of production in the case of a backlog. For example, Bailfield Industries, Incorporated, in the "financial highlights" section of their 1966 annual report, indicates that the Company has a backlog of some $40,252,000 in orders, with reported net sales for the year of only $31,328,000. In other words, the backlog of orders was greater than the reported sales for the year. Information on backlogs reduces the uncertainty of sales forecasting considerably.

In failing to capitalize their purchase commitments as current assets and liabilities, Sears, in effect, is able to omit these items from their statements permanently, in the amount of $1.4 billion. These purchase commitments may be substitutes for carrying inventory. If so, Sears' current position or current ratio is substantially improved by not capitalizing these items. A recent survey indicates large increases in the use of purchase commitments or "contract buying." 57 This survey provides a basis for concluding that if these contracts are permanent substitutes for current inventory, a

assets and current liabilities in financial statements, the extent of such substitutions is much more prevalent than realized.

The following statement, from the president's letter to stockholders of Puget Sound Power & Light Company (1966 Annual Report), further illustrates the importance to stockholders, of both order backlogs and contracts to purchase capital equipment.

Revenues received from industrial accounts increased 15% during the year. Our largest such customer is the Boeing Company which presently has a backlog of over $5 billion in orders for commercial jet aircraft. The aerospace firm's continuing contribution to our State economy also is strengthened by the selection of its design for America's supersonic transport, as well as numerous space and military contracts. Under a 20-year agreement signed in 1966, Puget will supply all of Boeing's power needs at both present and future plants within our service area.

The impact of the above information on stockholders is to give them some basis for predicting the future profits and progress, as well as some degree of certainty about those predictions. The operations of Puget, Boeing, and the government's space and defense operations are obviously linked to and heavily dependent upon the executory contracts mentioned above. This type contract may not only meet the so-called
minimum standards for relevance, but may, in fact, be among the most relevant type information presented in the annual reports.

A final example will illustrate the use and importance of purchase contracts. Frequently, companies purchase fixed assets or capital equipment through purchase commitments. For example, Eastern Airlines' 1966 annual report reveals commitments to purchase 80 fan-powered jet aircraft to be delivered in 1967 and 1968. The cost of these aircraft is in the hundreds of millions of dollars. Nearly two pages are spent in describing the financing arrangements undertaken, as well as those proposed for the aircraft. The importance of these contracts is signified by the attention devoted to their discussion in an unaudited section of Eastern's report.

Perhaps purchase commitments represent relevant information, which should be incorporated into financial statements, if the user of the statements is to receive a fair presentation of all assets and obligations of the firm under consideration. The monetary magnitude of most purchase commitments and the extent of their use, suggests that present methods of reporting purchase commitments in footnotes may
not be adequate. Perhaps their full impact will only be realized when they are capitalized and thus have a greater probability of being incorporated into financial statement analysis. At the same time however, it would seem that even if purchase contracts were capitalized, supplementary footnote data would have to be presented to enable the reader to independently assess the usefulness of information on such contracts.

Management Employment and Guaranteed Annual Wage Contracts

Executory contracts may often represent a "major event" in terms of the informational needs of users and, therefore, should be reported. Consider the following statements:

Many have asked with Professor Sorter why accountants treat the purchase of a glue pot as a recordable transaction and deny explicit recognition to a near-fatal coronary of the chief executive, who as a result now devotes his efforts to staying alive rather than furthering the interests of his organization. One factor is the accountants' traditional reluctance to make major estimates of this kind. This reluctance may be understandable, but these 'major' items are precisely the ones that need to be measured and reported. Many non-accountants, as well as practitioners, have encouraged the profession to re-evaluate these procedures and assign more
importance to faster and more specific reporting of major changes in expectations.\footnote{Carl T. Divine, "Some Conceptual Problems in Accounting Measurements," in Robert K. Jaedicke, Yuji Ijiri, and Oswald Nielson (editors), \textit{Research in Accounting Measurement}, American Accounting Association, Collected Papers, 1966, p. 20.}

Perhaps, if the contract with the executive in the above example had been recorded as an asset in the first place, his heart attack would have shown up as a decrease in assets and liabilities. Consider another aspect of this example. If the loss of the executive is considered such a financial tragedy, perhaps the employment contract was an asset which was worth reflecting in the financial statements. In particular, consider the capitalization of a contract between a corporation and one of its executives, whereby the executive agrees to serve in a particular capacity for a given period of time for specified compensation. Professor Shillinglaw discussed this type of contract and recommended that it be capitalized, although for different reasons than are set forth in this study.\footnote{Gordon Shillinglaw, "More on Doubtful Areas in Lease Capitalization," \textit{National Association of Accountants Bulletin} (November, 1962), pp. 9-13.} Assuming the executive is very
talented and of substantial notoriety, the reflection in financial statements, of this sort of contract, could be the most relevant of all information to some users. Creditors may lend money, stockholders may invest, customers may enter into supply contracts, and so on, simply on the basis of this information. To fail to report such evidence or information, which is substantiated by the existence of a contract, is to omit important, relevant information from financial statements. The financial reporting of most employment contracts is virtually nonexistent—a fact that is well known in most accounting circles. This practice is due to the difficulty of measuring and accounting for intangibles, such as managerial ability. Such difficulties should not be overlooked or minimized when considering capitalization of management employment contracts.

Corporations not only purchase executives' services for given periods of time at specified prices in specified jobs, they also purchase labor in similar fashion. For example, contracts covering 632,000 United Automobile Workers will expire September 6, 1967, and new ones are currently
coming up for negotiation. United Automobile Workers president, Walter Reuther, is demanding a guaranteed annual income for autoworkers. Reuther views the substance of the guaranteed annual wage as follows:

It's about like saying to General Motors that when a guy punches his time clock, you haven't got a contract to pay him for one hour. You have a contract to pay him a whole year's salary because that's the way you pay your corporation executives.

Perhaps the accountant should view labor contracts in the same fashion. The consequences of the contracts may be even more far reaching and of greater importance than management employment contracts in terms of competitive position, future costs and hence, future profits. The substance of these plans is to assure the covered workers a minimum weekly, monthly, or yearly pay check. Skillfully negotiated contracts of this type could mean tremendously increased profits, while poorly negotiated contracts of this type could spell a financial tragedy. The existence of guaranteed annual wage plans in one industry, which do not exist


61 Ibid.
in another, can very well bear on the investor's decisions. The existence of labor contracts makes labor costs more predictable and labor is frequently a high proportion of total costs in many industries. The existence of a contract gives some assurance that production will be uninterrupted, an event which could drastically affect costs, profits, dividends and debt-paying ability. In contrast, if the firm is a party to an unfavorable labor agreement, investors should be made aware of that fact.

If management employment contracts, guaranteed annual wage contracts or other forms of labor contracts could be recorded in some meaningful way in the accounts (as assets and liabilities) at the going market price, it would certainly be a step toward quantifying the service potential of management and employees— one of the corporation's most vital and valuable assets. Such recording gives the investor and other users an objective basis (market values) for assessing the corporation's ability to purchase the services of management and employees. After these assets and liabilities have been capitalized, they can be charged to income as used, in the same way as other assets are charged against revenue. These assets and liabilities have been
completely ignored in conventional financial statements and their accompanying footnotes because, as previously noted, it is difficult to obtain meaningful measures of them.

Construction Contracts

Another highly significant form of executory contracts are those used in connection with capital expenditure programs for plant expansion and construction, modernization, and the like. The drain on future resources, as well as the contributions or benefits expected from such programs, is entirely obvious, and is evidenced by the fact that companies seem compelled to mention capital expenditure programs, and the means of financing them, in their annual reports. Information on such contracts is relevant, and, in fact, is critically important to almost any user of financial statements. These contracts must be included in any substantive analysis of financial statements, including projected cash flow and fund flow analysis.

Financial Reporting of Executory Contracts

Almost all executory contracts are relevant accounting information—subsequent discussions reinforce this
conclusion. Thus, it becomes clear that the pertinent issue is not one of whether executory contract data are relevant information which should be reported. Rather, the issue becomes where and how should such contracts be reported, and how should their value be determined? Many executory contracts are already disclosed somewhere in annual reports, though often they are not covered by the auditor's opinion. The critical fact is that the present reporting of many executory contracts is inadequate. Even the reporting of leases, probably one of the best reported executory contracts, is sparse. Reporting statistics on some of the more important executory contracts from *Accounting Trends and Techniques* are presented in this chapter.

The preceding discussion suggests that executory contracts should be reported in published financial statements, and that they should be covered by the auditor's opinion. Subsequent chapters demonstrate the usefulness of reporting such contracts. Further, Chapter IV supports the conclusion that rights to service potentials or expected economic benefits (assets) and obligations (liabilities) arise under executory contracts. Their manner of presentation now becomes the paramount issue.
The two methods usually adopted for the reporting of accounting information have been to record the items and amounts in the accounts, or to disclose them in footnotes. Footnote disclosure, although better than none at all, is a poor substitute for capitalization of assets and liabilities and should only be used to amplify or further explain items and amounts in financial statements. Further, since it is shown in the next chapter that executory contracts (with few exceptions) represent assets and liabilities, it might be recommended that they be capitalized in financial statements. However, this recommendation must still be subject to the four constraints that executory contract data must be: (1) relevant information, (2) free from bias, (3) quantifiable, and (4) verifiable. In addition, executory contracts, if capitalized in financial statements, would seem to require further explanation in footnotes (and perhaps supplementary schedules), aimed at providing the reader with sufficient information to enable him to use the data in a meaningful way in his particular decision.

CHAPTER V

FINANCIAL REPORTING MODEL-OPERATIONAL DEFINITIONS

This chapter discusses whether or not executory contracts meet the criteria for assets and liabilities under generally accepted asset and liability concepts. Some operational definitions for the financial reporting model are investigated and developed. In other words, it would seem appropriate to consider how currently accepted concepts of assets and liabilities must be expanded, changed or interpreted, so as to accommodate executory contracts.

The purpose of this chapter must be clearly understood. Executory contracts may be demonstrated to be useful in practice, i.e., useful to users of published annual reports. Such a demonstration is crucial support for any suggestion that they be incorporated into financial statements. At the same time, however, executory contracts must be theoretically acceptable, i.e., accounting theory and principles must be applicable to executory contracts. In fact, the function of theory is to describe a wide range of practice. If it is useful in practice to consider executory
contracts to be assets and liabilities which should be reflected in financial statements, they must be incorporated into an existing, or new body of accounting theory.

**Asset Concept Used**

There seems to be a consensus that the concept of assets which should be used is one of "rights to future service potentials." Sprouse and Moonitz state the concept very concisely:

> Assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction.¹

These authors rely on and cite the long history of the future service potential concept of assets, to show that it has been utilized by such writers as Sprague, Paton and Littlefield, Vatter, and more recently, the AAA Committee on Concepts and Standards in their 1957 statement.² In addition, Canning has defined assets as follows:


An asset is any future service in money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some person or set of persons.3

Interestingly, in connection with the above definition, Canning did feel that the definition would be improved, or made more useful to all concerned, if the parenthetical material were removed.4 The implication is, of course, that executory contracts should also be included in the definition of assets.

In this study, the concepts and principles presented by Sprouse and Moonitz in Accounting Research Study Number 3, are used as a basis for the operational definitions for the financial reporting model. However, there must be several modifications, clarifications or changes in interpretation of these definitions before they can be said to accommodate executory contracts satisfactorily. Needless to say, professors Sprouse and Moonitz would not necessarily agree with these changes in meaning.


4 Ibid.
Classification of Terms

Three points or elements in the asset definition enunciated in Accounting Research Study No. 3 are relevant to the present discussion, and set the stage for the modification of the asset definition. In connection with the definition of assets, as rights to future service potentials, there are at least three elements of this definition which may or may not be entirely obvious:

(1) expected future economic benefits or service potentials,
(2) rights to those service potentials, and
(3) a current or past transaction.

These three elements will be considered in this order in the following paragraphs.

Degree of Uncertainty in Assets

The authors of Accounting Research Study No. 3 note that the adjectives "expected" and "future," as used in their definition, are to be interpreted as indicating that there is always some degree of uncertainty as to whether or not the economic benefits or service potentials will actually
result from the asset. The phrase, "economic service potentials," is to be interpreted in the same fashion. Note that the asset is really a potency, potential or expectancy. Although it will not be used in this chapter, some writers make an important distinction between service potentials of an asset and the expected service potentials or economic benefits—unless the user can abstract services from an asset, it has no value, regardless of its potential. This expectancy or potential is easily seen to be present in the case of executory contracts where the delivery of merchandise under a contract is awaited, the receipt of employees' services under a labor contract is anticipated, or there is the expectation of using leased equipment, buildings or land. The accountant has no alternative but to assume these contracts will be carried out, and that benefits or service potentials will, actually, result under contract.

This same expectancy attaches to the benefits to be derived from assets, other than those which arise under

5 Sprouse and Moonitz, op. cit., p. 20.

executory contracts. That is, some doubt is always attached to the benefits to be derived from any asset. There does not seem to be a substantial difference in the degree of uncertainty attached to the benefits expected to be derived from property which is leased as, opposed to that which is owned outright. Likewise, there may be as high a degree of uncertainty attached to the collection of an account receivable, as is attached to the delivery of raw material under a purchase contract, or the receipt of employees services under a labor contract.

The preceding discussion of uncertainty and expectation is very closely related to the traditional concept of the "going concern." Grady described this concept as follows:

The complexities of present-day business operations, with their high degree of technology, require long-range planning and research. Operating facilities with long-lived usefulness must be acquired, often by incurring long-term debt. Labor contracts with long-term benefits, such as pensions, must be negotiated to assure the necessary manpower for operations. All of these factors support the basic proposition that business managements assume, and properly so, the indefinite continuation of operations . . . .

. . . It (going concern) is nevertheless a unifying force behind a whole array of accounting practices and procedures in the so-called 'normal' case.
'Going concern' implies indefinite continuance. . . Indefinite continuance means that the business will not be liquidated within a span of time necessary to carry out present contractual commitments. . . . This view makes the concept one of tentative judgment, subject to revision in the future as contractual agreements are changed and plans and expectations with respect to operations shift.\footnote{Paul Grady, \textit{Inventory of Generally Accepted Accounting Principles for Business Enterprises}, Accounting Research Study No. 7 (New York: American Institute of Certified Public Accountants, 1965), pp. 27-28.}

The above concept applies to all business entities, not only the entity under consideration. Unless there is evidence to the contrary, an assumption is made that all business entities, with whom the firm under consideration is contractually or otherwise related, will, in fact, carry out all commitments. The accountant has no alternative but to assume that executory contracts will be carried out, executed or performed, and that the economic benefits or service potentials will, actually, accrue to all parties under the contract. Investors or creditors may, of course, take a different point of view in their financial analyses.

\textbf{Rights and Service Potentials}

With regard to the rights to future service potentials
which must be present for the enterprise to have acquired an asset, it need only be noted that the service potential of an object, person, institution and the like, may be present, but if the enterprise is to have an asset, it must also have a right (not necessarily a legal right) to those service potentials. An enterprise may possess service potentials, but if it has no right (legal, economic or moral) to those service potentials—as in the case of an illegally possessed object—it has no asset. This distinction in the service potentials and the rights to those service potentials will be referred to in a later section of this chapter, dealing with the existence of assets prior to their manufacture or physical existence.

Current or Past Transactions

Sprouse and Moonitz interpret the phrase "current or past transaction" as the event which brought the asset into the enterprise; this event is the "transaction." Future events or transactions are excluded from assets by use of the words "current" and "past."\(^8\) To clarify this

\(^8\)Sprouse and Moonitz, \textit{op. cit.}, p. 20.
interpretation, an example is presented, in which a piece of equipment already acquired is an asset, while a piece of equipment which the enterprise intends to acquire next year is not an existing asset, but merely a budgeted asset. That this elaboration is intended to, or would, exclude executory contracts as assets, is not entirely clear. The act of entering into an agreement, under which no performance has taken place, is not considered to be a transaction, according to traditional accounting theory. Thus, Accounting Research Study No. 3 would probably exclude executory contracts, since no transaction has taken place which would give rise to an asset. It is precisely at this point that asset definition of Accounting Research Study No. 3 must be expanded, changed or interpreted differently.

**Traditional Concept of an Accounting Transaction**

The concept of an accounting transaction lacks precise definition. However, there does exist what might be called the traditional view of an accounting "transaction." This traditional view suggests that a transaction is basically an exchange. For example, Paton and Dixon define an accounting transaction as: "any occurrence, process,
condition, or decision that results in an immediate change in the asset or equity elements of an enterprise." These authors are careful to exclude the entering into an executory contract as an accounting transaction: "... decision to purchase an asset sometime in the future is not a transaction; even the placing of an order is not a transaction." Husband and Schlatter interpret the term "transaction," as applying to "those business experiences in which there is an economic exchange of equal values." Husband and Schlatter also exclude executory contracts specifically from the category of an accounting transaction.

**Expanded Concept of an Accounting Transaction**

Alvin shows that Professor Moonitz, in Accounting Research Study No. 1, has considerably expanded the concept

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10Ibid., p. 62.

of an accounting transaction. Alvin presents a very convincing case, in order to show that, upon entering into or executing a lease agreement, an accounting transaction has occurred, which should be recorded in the accounts. If Moonitz's B-2 Postulate and his transaction concept are accepted, leases "will be recorded and formally presented in the financial statements at the time the lease arrangement is signed." Moonitz's Postulate B-2 states: "Accounting data are based on prices generated by past, present, or future exchanges which have actually taken place or are expected to." Further, in Moonitz's view, accounting transactions are "instances of financial events (transactions) involving at least two accounting entities." Basically, Alvin's reasoning is that two accounting entities are usually involved in the lease agreement and the mutual promises exchanged in a lease agreement may represent a past or present exchange,


14 Ibid., p. 28.
and certainly do represent a future exchange which is expected to take place. Particularly in the case of leases, other writers, notably Rappaport, would agree that the exchange of promises, which are legally enforceable, does give rise to assets and liabilities under the transaction concept. Rappaport's analysis suggests "that the prevailing transaction concept be extended to accommodate the recognition of lease contracts and other comparable commitments."

Vatter lends strong support to the preceding contention that the execution of the lease agreement is a recordable accounting transaction. Says Vatter:

The lease is a complete transaction. The relations established by the contract are positive and specific; even though certain acts are unperformed, the arrangement is incomplete only in the sense that it involves future time. Although performance and compensation are extended over a time period, no special event or action is required to make the arrangement effective, nor is there any cancellation by offset, or termination by conditional events. There are definite obligations created by the contract;

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15Alvin, op. cit., p. 43.


17Ibid., p. 373.
these, since they can be enforced in the same way as other business commitments, have all the attributes of liabilities.

The counterparts to those liabilities are perfectly valid assets. The lessor's right to compensation is an enforceable money claim, which is unquestionably an asset.\(^\text{18}\)

Unquestionably, in Vatter's view, the execution of a lease contract involves an exchange of property rights, which gives rise to assets and liabilities under the transaction concept. Vatter does not have to strain to arrive at this conclusion, but rather works within the framework of the relatively simple concept that an accounting transaction is an exchange. Vatter's analysis seems to be applicable to other types of executory contracts.

\textbf{Additional Support for Expanded Transaction Concept}

Additional support can be found in Bedford's writings to show that entering into a contract involves an exchange of economic rights, which fulfills the requirements of being an accounting transaction.\(^\text{19}\) The preceding analysis suggests


\(^{19}\)Bedford, \textit{op. cit.}, pp. 114-19.
that the relevant question is really one of when to recognize the existence of assets and liabilities, or when to recognize the acquisition of the services of these assets and the resulting obligation to pay for them. The exchange of promises (at the signing of the contract) represents an exchange of rights to future service potentials, and so, may be a valid point at which to recognize assets and liabilities.

According to Bedford, "a transaction takes place as the result of a 'deal' with an outside person." Further, economic activity, the subject matter of accounting, is a continuous process whereas transactions are "discrete points" in this continuous process. "Transactions are specific points in this process, loosely categorized as an acquisition (purchase), a disposition (sale or scrapping) or an exchange." He notes further, in connection with the relationship of the accrual process to the transaction


concept, that the accrual process bridges the gap between the "acquisition of a fixed asset (the initial transaction) and the disposition or sale of the fixed asset (the final transaction) . . . ." 23 The problem, in the case of executory contracts, is determining when the initial transaction takes place, or when the asset is acquired. A good argument can be presented that the rights to future service potentials arise at the point of signing the contract. This is the point at which the relevant transaction takes place, or the relevant exchange (of promises or rights to future service potentials) takes place.

Bedford makes another very important point, that the transaction (a discrete point) is often confused with the activities leading up to the transaction:

For example, the process of acquiring material, labor and other resources and using them to make a shoe has been defined as the one transaction of making a shoe. Another illustration of this same confusion is the tendency to treat all work performed by one employee, until he has been paid, as one transaction. In its most realistic form this concept of a transaction would consider all activity (planning, ordering, receiving and storing) involved in acquiring an item of merchandise as a transaction.

23 Ibid.
This concept considers a transaction an activity rather than an exchange.24

Using Bedford's explanation of the transaction concept, it may be argued convincingly that the signing of a contract and the exchanging of mutual promises is, actually, the first discrete point (in the time sequence involving the acquisition of an asset) at which an asset should be recognized in the accounts in the form of rights to the performance of services arising from the contract. The subsequent performance and rendering of services under the contract, merely change slightly, the form of the asset and corresponding liability. For example, in terms of a long-term purchase contract, the right to the service potentials of the goods under the contract could be treated as an asset receivable by the purchaser, with a corresponding long-term liability. As the goods purchased under the contract are received by the purchaser, that asset form is converted from being merely goods or merchandise receivable, to an inventory account. The corresponding long-term liability becomes a current liability to the extent of the goods delivered.

24 _Ibid._, p. 31.
When to Recognize Assets

The issue is clear. When should the acquisition of the asset (goods or services) acquired under contract be recognized? Bedford considers several possible points at which the asset might be considered as having been acquired. Conventionally, accountants have restricted themselves to three dates for recognition of the acquisition of assets. These dates are: (1) the date title passes, (2) the date the goods or services are physically received, and (3) the date cash is paid for the goods or services. There is no reason why accountants should restrict themselves to these dates. Rather, as noted by Bedford, goods or services should be recognized as having been acquired as soon as sufficient evidence is available to indicate the goods or services will be used by the enterprise. This early recognition of goods and services results in a more complete presentation of accounting information in published

reports. A more complete record is certainly a more useful and more informative record. To omit transactions because they do not coincide with one of the above arbitrary dates, is to omit "significant information on resources effectively acquired," and results in failure to disclose, as fully as is possible, the anticipated future actions of the enterprise. In addition to leases, Bedford cites another illustrative case, where an asset would properly be recognized upon entering into a contract.

For example, mere discussion of the desirability of acquiring a certain type of machine would not be sufficient evidence to recognize that services in the machine were going to flow into the use of a specific business firm. On the other hand, the placing of an order for the machine might be sufficient evidence, for accounting purposes to warrant treating the services in the machine as having been acquired.

Bedford, and at least one other current writer, have stated the principle that the acquisition of services and goods should be recognized as soon as the acquisition cost is

\[26\text{Ibid., pp. 114, 117.}\]

\[27\text{Ibid., p. 116.}\]

\[28\text{Ibid., pp. 114-15.}\]
known or measurable. In addition:

One might contend that acquisition cost is known as soon as the contract for the acquisition is accepted by both parties to a purchase and sale of services, and that this date should be used to recognize services acquired.

... An early recognition of service acquisition is desirable. It permits a determination of several types of operational income. This does not mean that all services so recognized must be disclosed on the balance sheet. There may be reasons why, for balance sheet purposes, another recognition point may be appropriate for the determination of assets. 30

It would seem that an early determination of total assets and liabilities would also be desirable in terms of giving investors and creditors a more complete picture of financial position. It would give them a more accurate reflection of the total economic services available for use during the succeeding periods, as well as the total demands on company resources to meet the corresponding obligations.

The preceding discussion suggests that the present concept of accounting transaction not only can, but perhaps


should be expanded or interpreted to include the signing of a contract as a transaction which gives rise to the recording of assets and liabilities. With this modification (or explanation, in case this is the correct interpretation intended by Accounting Research Study No. 3), the Sprouse/Moonitz definition of assets is accepted without further qualifications, for purposes of this study. The conclusion might also be inserted at this point, that whether one takes a pragmatic approach or a definitional approach (i.e., constructing operational definitions for theoretical concepts), he arrives at the same point. That is, that executory contracts should be reported if they represent useful, relevant information to users of the data.

**Liability Concepts**

The preceding discussion lays the groundwork and makes acceptance of the Sprouse/Moonitz liability definition an easy matter. With the previously discussed interpretation of an accounting transaction, the following definition is used with no further qualifications in this study.

The liabilities of a business enterprise are its obligations to convey assets or perform services, obligations resulting from past or current
transactions and requiring settlement in the future. The term 'obligations' connotes a claim or series of claims against the business enterprise, each of which has a known or reasonably determinable maturity date and an independent value which is known or reasonably measurable.  

Bedford's principle of a known acquisition cost or value is also operative with liabilities, i.e., the value of the liability must be known or reasonably measurable, before recording it in the accounts is justified.

**Relationship of Transactions to Assets**

The whole transaction concept should be related to the idea of the service potential concept of assets. This relationship results from the principle that an asset should be reported, whenever it possesses a measurable economic service potential. An asset usually has a measurable economic service potential when an exchange takes place or a transaction occurs. Admittedly, it is not always possible, practically speaking, to determine the precise moment at which an asset comes into existence. But, it is logical to state, on the basis of the preceding discussion, that the point at

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which the parties enter into a contract—the point at which there is an exchange of promises (transaction) giving rise to economic, legal and moral rights and obligations—is the point at which rights to economic service potentials arise. The point at which this transaction or exchange takes place may thus be used to recognize the acquisition of assets and liabilities arising under a contract. The operational principle previously mentioned, states that an asset can be recorded if it possesses a measurable economic service potential or measurable future economic benefit. In the case of executory contracts, these benefits must first be shown to exist, before taking up their measurability.

The Existence of Service Potentials or Economic Benefits

The first argument which might be presented to show that future service potential exists in an executory contract, is the very obvious fact that an enterprise would not enter into a contract, unless there were rights or benefits received under that contract. Unless there was some expected value or benefit to entering into an agreement, or expected value received under the agreement, there would seem to be
no need for a contract. In fact, the contract and the rights under the contract should be thought of as being identical. These rights can be seen in a negative way. A company, that was not able to operate at full capacity because it failed to enter into a contract which would guarantee supply, can easily appreciate the economic benefits which arise under the contract. So also, the company that does not produce as a result of a labor strike could hardly argue that a labor contract (if they had one), or the rights received under the labor contract, provided no value or benefit. Measuring the value of these rights is, of course, another problem to be discussed in Chapter VI.

The asset value of rights received under a contract can also be seen from the viewpoint of the liabilities which arise in connection with the acquisition of these rights. One could hardly argue that the company entering into a contract does not incur any obligation or liability to provide future service or benefits. The existence of these obligations is readily apparent, even though contingent upon the receipt of goods and services. Such obligations are simultaneously, service potentials or economic benefits to the other party to the contract.
In terms of executory contracts, the rights to service potentials received under the contract are the rights to the goods, services or other resources to be rendered by the other party to the contract. The enterprise of course, simultaneously assumes obligations in return for the other party's services. The value of the service potentials acquired need not be equal to the value of the obligation to render service potentials. The obligation may be discharged at a rate different from the rate at which an asset is consumed. In sum, every executory contract changes the total economic rights acquired by the enterprise and changes the total of the economic obligations assumed by the enterprise. An asset's service potential lies in its ability to enhance the future operations of the enterprise, whether that be in the form of increasing the income stream of the enterprise or in the form of aiding in the achievement of some other objective of the enterprise.

Contract Rights Versus Rights to Service Potentials

The rights received under a contract are precisely rights to service potentials of the object of the contract. The rights received under contract and the rights to the
service potentials are one and the same set of rights. However, sometimes the contract itself is thought to have a service potential distinct from the service potential which is the object of the contract, and is received under the contract. For example, a lease and almost any other contract can be sold. This lease contract is considered to be distinct from the right to the service potentials of the leased asset. This same analysis can be applied to stock options or purchase contracts, wherein it is argued that the contracts themselves are assets (called indirect service potentials) apart from the stock (direct service potentials) which can be acquired by exercise of the option, and apart from the merchandise (direct service potentials) which can be acquired under the purchase contract. The argument used to support this contention or analysis is the fact that a lease contract, stock option contract, purchase contract or any other contract, for that matter, can be sold for a price above or below the price fixed in the contract. Birnberg explains it in this fashion:

The direct service potentials arise from changes in market conditions that make the terms of the contract either more or less desirable. A price rise subsequent to the time of a purchase agreement makes the agreement, like a stock option, take on value
approximately equal to the difference between the market price and the agreement's price. Similarly should the price fall subsequent to the agreement, its service potential would be negative.\textsuperscript{32}

This analysis might be challenged for at least two reasons.

**Negative Service Potential—An Impossibility**

First, Birnberg's analysis permits the agreement (a supposed asset and therefore service potential) to have a negative service potential. However, "negative service potential" is a phrase and concept which may be difficult to comprehend. An object has service potential when its use will increase the income stream of the enterprise. Thus, service potential is the expectation of a positive use being abstracted from the object. The terms "negative" and "asset," or "negative" and "right to future service potentials" are mutually exclusive, i.e., by definition, one term or concept excludes the other. Use of both these terms in describing the same concept is analogous to attempting to represent a mathematical series or statistical universe, as being both finite and infinite at the same time. Such a state is obviously impossible, for the states of

finiteness and infinity are, by definition, mutually exclusive. In the sense that a state of finite-infinity is impossible, so also, is "negative service potential" an impossibility.

Also relevant to the present discussion is the idea that all assets, by definition, must have a positive value. One can argue about the value of service potentials, or the value of rights to service potentials, or how that value should be measured. In other words, one can think of the existence of assets as being distinct from the valuation of those assets, as long as they have a positive value. It should be noted, however, that this distinction is possible only for purposes of theoretical analysis. Concepts, such as "asset" and "zero valuation," are mutually exclusive. One can, of course, argue about the magnitude of the values involved. Rights to "economic benefits" or "service potentials" (assets) imply some positive value. There is no asset when its value is zero.

In sum, service potential, by definition, is something positive. Thus, negative service potential is really an absence or lack of service potential. Therefore, it is difficult to imagine that a buyer is willing to purchase this
lack, or absence of, service potential (i.e., negative service potential) at any price. Thus, Birnberg's analysis permits a contract which lacks, or has no service potential, to have a positive price or value.

**Contract Is a Verbal Description and Has No Service Potential**

Second, a contract is a written or verbal description of the right to the service potentials of the object of the contract, and has no service potential. All rights to service potentials (assets) acquired by an enterprise are acquired under contract. In Chapter III, the corporation was conceived of as a "bundle of contracts." In this same sense, all assets are acquired under one contract or another. When a corporation makes a cash purchase, it is acquiring the right to the service potentials of the object of the contract, in spite of the fact that a written contract has not been made. The contract is evidence of the existence of the corporation's right to the service potentials of a particular good, resource, person, but is not, in fact, that service potential or does not itself possess service potential, apart from a particular good, resource, person, and such, which is the object of the contract.

The object of an executory contract cannot be viewed
or thought of as being apart from the agreement or contract. One would not purchase a lease contract for its own value—it has no economic benefit, apart from the object or asset to be used under the lease. It becomes difficult to think of a purchase contract as having any value, apart from the merchandise that is the subject of the contract. All service potentials under executory contracts are direct service potentials. What Birnberg calls indirect service potentials (the value of the contract itself) seem to be holding gains and losses. Holding losses are what Birnberg calls negative service potentials.

In a sense, a contract is a tool for describing the acquisition of rights to service potentials. The reason executory contracts, such as leases, purchase contracts and stock options, to name but a few, can be sold at a price above or below the contract price is that the market has reappraised the value of the direct service potentials (stock, under a stock option contract, use of the leased asset under a lease contract, the goods under a purchase contract) and finds that their value is higher or lower than the value fixed in the contract by a previous exchange or transaction—which the contract describes. For this reason,
the difference between the market price and the contract price does not indicate the existence of indirect service potentials, but rather, indicates the existence of holding gains or losses arising from the holding of rights to service potentials.

An Example

If two companies, which can be considered to be identical in all respects (A and B), enter into a contract whereby B is to purchase 100 units of X product from A, for $150, the contract relationship might be depicted as follows:

Contract

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<table>
<thead>
<tr>
<th>Co. A</th>
<th>SP₁</th>
<th>Co. B</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>←-----</td>
<td>--- →</td>
<td>SP₂</td>
</tr>
</tbody>
</table>
```

SP = Service Potentials

100 units of X = SP₁ is an asset to B and a liability to A

$100 cash = SP₂ is an asset to A and a liability to B

What Birnberg is calling the value of the contract or indirect service potentials, is really a change in value of SP₁
relative to SP₂. Assume, that prior to delivery to B and because of an unforeseen scarcity of product X type resource, the value of 100 units of X rises to $150. In short, Birnberg would attribute the $50 relative change in the value of SP₁ to the contract. Anyone (for example Co. C) wishing to purchase these same 100 units, will have to pay $150 to B. Birnberg would be forced to say that C is paying $50 for the contract and $100 for the 100 units of X product—an obviously weak position. In this example, the contract may be thought of as an inert device or tool for describing the acquisition and disposition of the rights to service potentials.

The preceding discussion supports the conclusion that the rights to service potentials involved in an executory contract lie in the rights to the service potentials of the object of the agreement. The rights received under a contract are identical with the rights to the service potentials of the object of the contract. Thus, the asset acquired under an executory contract to lease a piece of equipment, is the right to the service potential of the equipment. The asset acquired under a contract to purchase raw materials is the right to the service potentials of the raw materials.
These rights have no value, apart from the service potentials of the object of the contract under which they are acquired.

Thus, the original question becomes: to have acquired an asset is it necessary to have immediate availability of the use of the object's service potential? In terms of the asset definition being used in this study, this availability for immediate use does not seem to be a required element. The two requirements of future service potentials and rights to those future service potentials can be present, whether or not the object of the contract exists.

In the case of intangibles, the argument cannot be made that they are not assets because they have no physical existence. The service potential of intangibles lies in the fact that people or institutions will act, or refrain from acting, in a certain manner which will, in turn, alter or affect the income stream or other objectives of the enterprise. The service potentials, as well as the rights to service potentials of intangibles, exists then, only in the minds of men. Hence, service potentials can exist prior to, and independent of, the physical existence, i.e., it can exist in the minds of men.
In the case of tangible assets, if it is argued that the service potentials of the object of the contract must be available for immediate use for an asset to exist under an executory contract, another interesting question arises. That is, it is an inescapable fact that one can never be certain that service potentials will flow from an object until the services are actually abstracted from the object or asset. Thus, one could never be certain of the existence of an asset until the actual service is derived from the object of the contract. It should be emphasized that "service potentials" are not "actual services." The asset definition used in this study does not require that actual services be present, only service potentials. Focus on the word "potential" in the asset definition, and it is not inconceivable that the service potential of an uncreated object may be no less real or no less certain than the service potential of a created object.

Existence of Service Potentials Prior to Existence of the Object of the Contract

The question arises as to whether or not an asset is derived from an executory contract wherein the object of the
contract does not yet exist. For example, if a firm signs a contract to lease a building or have a building constructed, can the lessee, or purchaser, be said to have acquired an asset under the contract, if the building has not yet been constructed? A clear distinction in the elements of an asset is necessary to the investigation and discussion of this question. An asset was defined as consisting of future service potentials and rights to those service potentials. The future service potentials of the building, which is the object of the executory contract mentioned above, consists of the ability of that building (object) to increase the income stream of the enterprise, or further other objectives of the enterprise. It must be conceded that an enterprise cannot use the services of a building which does not yet exist. However, the future service potential of the contract is not the building (tangible object), but rather the services or functions which are expected to flow from this building. The asset, then, consists of the rights to the future service potentials which are expected to flow from the building (object of the contract). If fine distinctions are permitted, it might be argued, that whether or not the building (object of a contract) is capable of providing
services now, is not relevant to the question of whether or not an asset exists under the lease contract or construction contract. Actually, the future service potential of the building may be unaffected by the fact that the building does not presently exist. The difference between a building which is on the drawing boards, and one which is already constructed, is that the service potentials are closer to realization in the case of constructed building.

This problem can be approached in another way, since it may be difficult for some to accept these mental gymnastics, and difficult to see how an asset can exist under a contract (to purchase inventory or to construct a building, for example) when the object of the contract (merchandise, or building) has no physical existence at the date the contract is negotiated. It can probably be stated that, whether or not the merchandise or building in the above type contracts exist, is not relevant or can be ignored safely, as long as the right to these objects has been acquired and the creation and delivery of these objects has been promised. In other words, if the going concern concept is brought into the picture, it is suggested that the accountant must, of necessity, assume (unless there
is evidence to the contrary) that the object will, in fact, be created. It has never been considered unrealistic for the accountant to rely on the going concern concept when the necessary degree of certainty is present. The case of executory contracts may simply be another instance in which it can be deemed useful for the accountant to rely again on the going concern concept.

**Capitalization of All Expectations**

If one would consent to capitalize all executory contracts, why not capitalize all expectations, i.e., why stop with the occasion of the contract, for recognition of assets and corresponding liabilities? In other words, why not capitalize the expected future sales or earnings of the company, as predicted by the company's president, or why not capitalize, as assets and liabilities, the company's proposed capital budget. The company's capital budget might be capitalized even prior to the letting of contracts or perhaps, even prior to its acceptance by the appropriate budget committee or other company executives. There are several reasons for not capitalizing prior to the existence of or signing of a contract.
First, the signing of, or entering into the written contract, is an objective manifestation of the commitment of the firm. In fact, it is even a legally binding commitment. In other words, the contract serves as concrete evidence, particularly when coupled with the going concern concept, as discussed earlier, of the fact that the firm has acquired promises of future economic benefits which are expected to be derived from, or abstracted from, the object of the contract. This same objective type evidence is frequently not present prior to the formation of the contract. Such is the case with capitalizing future sales, or earnings, or the proposed capital budget mentioned earlier.

In this same context, however, it should be noted that, in those cases where either or both parties have no intention of fulfilling, or an inability to fulfill the contract, or there is evidence to indicate that the going concern assumption is not valid, no asset has been acquired, no liability has been incurred, and none should be recorded or reported, in spite of the existence of a contract. There can, of course, be legal complications where one party has performed. This would also be the case where one of the parties has already performed on the contract and performance
cannot be reversed. Ignoring these legal problems, in this simple case where no performance has taken place, the asset and corresponding liability and revenue amounts should be removed from the accounts, when the contract is not to be fulfilled.

Second, the contract serves as evidence that another, independent party to the contract has also committed itself to the transaction, and has agreed to do whatever is necessary to fulfill the contract for the acquisition of service potentials. In other words, when the other party, outside the corporation, becomes a part of the contract, an exchange of promises or a transaction (according to one interpretation of the transaction presented earlier in this chapter) has taken place. Prior to the formation of the contract, there is only the intention of one or both parties to be committed, which in the absence of each party's legal commitment, might generally be considered insufficient evidence to indicate an exchange has taken place or a transaction has occurred.

In addition, generally, with the formation of the contract also comes the establishment of exchange prices for the assets and corresponding liabilities involved in the
contract. Prior to exchange of the rights and service potentials under the contract, most assets would not be easily measurable by a particular firm. At the same time, it should be noted that at some time in the future it may be feasible to incorporate into financial statements, expectations or future transactions which have not been verified by an exchange or by contract. The usefulness of such information in future predictions and decisions would be advocated by some and disputed by others—this is a matter which must be settled by research. However, in the absence of objective evidence to substantiate these expectations, they cannot be recommended for inclusion in published financial statements.

In the context of the preceding discussion, it might also be asked why not capitalize economic commitments? If it is to stay in operation, the company must purchase or is committed to purchase the services of utilities and other such common asset services. There are at least two reasons for omitting economic commitments. First, no contract has been formed, and so, no exchange or transaction has taken place. But, in addition, these services are readily available to all users in the market, and thus, information
on such economic commitments is probably irrelevant to the decisions of most users of financial statements. If these common service potentials were to be purchased via some long-term agreement or contract, their reporting might be relevant, since the firm: (1) may have been speculating, which necessitated entering into a fixed commitment at fixed prices, or (2) may be substituting executory contracts for assets, as in the case of purchase commitments for inventory. Barring the existence of such a contract, however, the investor or other users would assume that these readily available service potentials or assets will have to be purchased, if the firm is to continue in operation.

The Effect of Executory Contracts on
The Income Statement

It should also be noted that recording executory contracts is essentially a balance sheet problem, or one of correctly presenting the financial position of an enterprise. If the view is taken that profit is the result of measuring net assets at two different points in time, it appears that recording of most executory contracts will not affect income in the period first recorded, unless of course, replacement
cost or other current cost used, changes substantially. Admittedly, the value of the asset and liability recorded can be different, but this is a measurement problem to be discussed in Chapter VI. In short, since net income or net profit is defined as the increase in net assets, profit does not seem to arise as a result of recording most executory contracts in the accounts and financial statements. In the case of a contract which is completely executory, very often net assets will not have changed as a result of the recording, and for that reason, profit has not been created. Thus, there is no need to get heavily involved in income measurement or revenue recognition in this chapter.

The framework used in Accounting Research Study No. 3 for presentation of the income statement is accepted in this paper as an adequate income reporting model for executory contracts. The general concepts to be used in determining income in connection with executory contracts are adequately described in Accounting Research Study No. 3 and need not be elaborated in detail, here. The following quote, which sets forth only the broadest operational concepts used, should suffice:
Net profit (earnings, income) or net loss for an accounting period is the increase (decrease) in owners' equity, assuming no changes in the amount of invested capital either from price-level changes or from additional investments and no distribution to the owners. Revenue is the increase in net assets of an enterprise as a result of the production or delivery of goods and the rendering of services. Expense is the decrease in net assets as a result of the use of economic services in the creation of revenues or of the imposition of taxes by governmental units. Gains are increases in net assets other than those resulting from additions to invested capital or from revenues. Losses are decreases in net assets other than those resulting from reductions in invested capital or from expenses.

The matter of such things as holding gains and losses is relevant to a discussion of executory contracts. However, this is largely a measurement problem, and as such, will be taken up in Chapter VI. Likewise, the fact that reported income is often related to total assets or total equity as a measure of performance, suggests that the income statement is indirectly affected by executory contracts. This problem will also be considered in Chapter VI.

Summary

The previous chapter demonstrated, by reference to

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33 Sprouse and Moonitz, op. cit., p. 9.
several types of contracts, that executory contract information is relevant financial information to typical users of published financial reports. The future economic burdens or benefits, as the case may be, of pensions, leases, purchase commitments, various employee benefit contracts—to name but a few contracts—are often reported in financial statements, but only in footnotes or in other sections of the report not covered by the auditor’s opinion.  

In this chapter, executory contracts were examined in light of basic theoretical accounting concepts, to determine whether or not existing concepts and definitions can accommodate such contracts, and also to determine the extent to which these concepts and definitions must be changed or modified so as to be descriptive of executory contracts, as well as existing accounting practice. Generally, it is accepted that all assets (future economic benefits) and all liabilities (future economic burdens) of the enterprise constitute relevant, useful information to users of external reports. Not only is executory contract

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information relevant, but, theoretically, executory contracts may qualify as assets and liabilities which should be recorded in the accounts. Executory contracts, even within the context of present concepts of assets and liabilities, i.e., on the basis of theoretical definition, seem to qualify as assets and liabilities. If, in addition to the relevance standard, executory contracts meet the standards of verifiability, freedom from bias and quantifiability, there may be no compelling reason why executory contracts should not be recorded in the accounts, amplified in footnotes, and thus, readily incorporated into all conventional financial statement analysis by external users.
CHAPTER VI

THE EFFECT OF CAPITALIZATION ON
SELECTED FINANCIAL RATIOS

This chapter is primarily an attempt to illustrate how executory contracts might be capitalized, as well as the effect of such capitalization on selected financial ratios. Application of replacement cost (current cost) and price-level changes are also treated briefly, along with a discussion of how the concept of holding gains and losses might be modified somewhat by capitalization of executory contracts. Also, the use of other reporting procedures, such as a funds statement and supplementary schedules, are discussed, briefly. With respect to the effect of capitalization of executory contracts on financial ratios, the objective of this chapter is to determine the extent to which the selected ratios change and more importantly, to determine the extent to which their interpretation is changed and made more or less meaningful.
Replacement Cost and General Price Level Changes

It would seem that replacement cost and price level adjustments could be applied to the valuation of executory contracts. As pointed out by Sprouse and Moonitz, the use of each of these concepts overcomes an important deficiency present in using historical cost (contract price in the case of executory contracts). In the case of general price level changes:

Changes in the dollar itself . . . are not reflected at all at any time, so that their effect is confused and mixed in with the effect of changes in specific prices. Some portion of what is reported as profit (loss) should actually be classified as a restatement of capital resulting from a change in the measuring unit.¹

In the case of replacement cost:

Changes in the specific prices of individual items, such as inventories, or plant and equipment, are not recorded until 'realized.' The total profit is reflected in the period of realization and not apportioned to the periods during which the profit accrued.²


²Ibid.
Use of replacement cost (current cost) and general price level changes would overcome these difficulties in the valuation of all assets, including executory contracts. Thus, it would seem that these concepts are just as useful in valuing executory contracts as they are in valuing any other asset or group of assets, and as a consequence, detailed lists of advantages and disadvantages of these two valuation concepts need not be presented here. Such lists have been adequately presented in current accounting literature. However, it might be pointed out that perhaps market prices of particular executory contracts may be more difficult to obtain than are market prices for most other assets. In other words, a ready market does not exist for most executory contracts and thus, the implementation of current cost for such contracts may be more difficult. This may be somewhat of a unique problem in valuing executory contracts at replacement cost.

In contrast, there would also seem to be a unique advantage to recording executory contracts in the accounts and subsequently valuing them at replacement cost. Holding gains and losses arise in connection with the use of replacement cost or current cost. Full implementation of the concept of replacement cost, and hence the recognition of
holding gains and losses requires that all executory contracts containing fixed prices (or a way of fixing prices in the future, which will allow them to differ from replacement cost) be recorded in the accounts at the date the agreement or contract is negotiated or signed. Conceivably, a second procedure could be utilized, whereby the holding gains and losses could be reflected by a specific adjusting entry, without recording the contract itself in the accounts. Both procedures would accomplish the same objective of recording the holding gain or loss in the period in which it occurs. However, the latter procedure would have the disadvantage of recording holding gains and losses on assets which do not appear in the accounts or financial statements. Such a practice may be confusing to users of the statements. All of the preceding discussion requires further explanation.

When assets are purchased and held by a company while the specific prices of these assets change, holding gains and losses occur. "Holding gains" arise when the current cost or replacement cost of the asset held rises above historical cost. "Holding losses" arise when the current cost or replacement cost of the asset held falls below historical cost. The objective in reporting holding gains and losses
is to separate profits or losses arising through normal operations, from profits or losses resulting from the holding of assets during periods of changes in their specific prices. For example, assume an item of inventory was purchased for $50, at the beginning of period one. Assume further that its replacement value at the end of period one was $70, and when sold in period two for $100, its replacement value was $85. Conventional income reporting would reflect an operating gross profit of $50 ($100−$50). In reality, however, there was a gain from holding the asset, at the end of period one, of $20, and during period two, a holding gain of $15 and an operating gross profit of $15.

Although some writers would say that the holding gain of period one of $20 is unrealized, others see no useful purpose in distinguishing realized and unrealized holding gains and losses.\(^3\) Edwards and Bell would say the $20 gain was unrealized, and Sprouse and Moonitz would probably agree.\(^4\)


However, Sprouse and Moonitz would state that "no useful purpose is served by delaying recognition of holding gains and losses until realized."\(^5\) Unless it is proposed that holding gains and losses be ignored until realized through the use of assets in the production of revenue, executory contracts should probably be recorded to give effect to such gains and losses.

In terms of executory contracts, assume inventory is purchased under a contract in which its price is fixed at $50 in period one. To be able to recognize any holding gains or losses which arise during the time the inventory is purchased and sold, the contract might be capitalized. Changing the previous example slightly, assume the inventory purchased under a purchase contract in period one, is delivered and paid for in period two. The merchandise has a replacement value at the end of period one of $70 and when sold in period two for $100, its replacement value was $85. Unless the purchase contract was capitalized as an asset in period one, it would be difficult (unless a memorandum entry is used) to give effect to, or recognize

\(^5\)Sprouse and Moonitz, *op. cit.*, p. 17.
the $20 holding gain as part of income in period one.

Thus, any time the price of the executory contract is fixed, it permits holding gains and losses to be measured and reported. If no asset is recorded until the contract is partly executed or performed (delivery or payment is made), several periods hence, there is a presumption that the price paid say in period two (fixed by contract in period one) is the current price. Therefore, all the holding gain is recognized in period two and none in period one. Because of this, all executory contracts, in which fixed prices have been established for the future service potentials, can be recorded to permit the proper recognition of holding gains and losses as they occur period by period.

Holding gains and losses might be computed on all assets, including executory contracts, to serve as a basis or indication of management's effectiveness in acquiring or negotiating for future service potential. Such a computation not only allows the separate evaluation of management's ability to use (yielding operating profits) assets versus their skill in acquiring assets (yielding holding gains and losses), but also permits the determination of managerial effectiveness at a much earlier point in time.
That is, the date a contract is entered into, versus the date(s) performance takes place by delivery or making payment, may be separated by a considerable time period, during which holding gains and losses are occurring and going unnoticed.

As a concluding note to this section, it should be mentioned that, while many theoreticians are advocating the separation of holding gains and losses from regular operating income, this is not now being done in practice. The practical application of the concept of holding gains and losses may involve so many practical difficulties, that a meaningful implementation of the concept may not be impossible.

**An Illustration**

The next section of this chapter is basically an attempt to capitalize five types of executory contracts, along with an examination of the effect of these contracts on financial ratios and financial analysis. In addition, methods of reporting, other than capitalization, are treated very briefly. Both the discounted and undiscounted amounts of selected contracts are presented in journal entries and capitalized in financial statements. The effective market
rate of interest is used as the discount rate. When contracts other than leases are discounted, entries are required in each subsequent period to add a like amount to both the asset and corresponding liability accounts (equal to the effective market rate of interest times the balance in the account). In this way, the present value of the cost of the asset can be shown without affecting the reported income, by the recording of both interest income and interest expense.

6In Accounting Research Study No. 3 (page 39), Sprouse and Moonitz suggest that liabilities calling for settlement in cash, be valued at the present, discounted value of future payments or its equivalent. In measuring the liability they suggest further that "if the creditor will not or cannot accept cash now in discharge of the liability, the appropriate amount is that sum which, if invested now (e.g., in a sinking fund), will provide the sums needed at maturity, even though in fact no explicit sinking fund or other investment device is actually used." This statement leads one to question whether or not the effective market rate of interest should be used as the discount rate. The sum which must be invested now, would seem to depend upon the rate at which this same amount can be invested by the debtor-firm. Thus, to achieve the measurement suggested by Sprouse and Moonitz may require that the earnings rate of the debtor-firm rather than the effective market rate of interest (earnings rate of the creditor), be used as the discount rate. However, at the present time, use of an earnings rate as the discount rate, would seem to present almost insurmountable measurement and reporting difficulties.
After journalizing the capitalization of contracts, the subsequent discussion of ratios is presented in terms of undiscounted amounts. It will be noted that there are only slight changes in the ratios when undiscounted versus discounted values are used. Hence, the discussion could have been presented in terms of either value. The most important aspect of this illustration is the very marked change in financial ratios and their possible interpretation or meaning as a result of capitalizing executory contracts. In sum, this section serves as a simple illustration of what financial statements would look like, and how traditional ratios and their interpretation, as well as acceptable norms for these ratios, might change as a consequence of capitalizing executory contracts.

**Ratios and Contracts Selected**

In addition to a discussion of working capital, five ratios selected for analysis are as follows:

1. Current Ratio
2. Debt to Equity (and Total Debt to Total Assets)
3. Net Income to Total Assets (Rate of Return on Investment)
(4) Cash Flow to Total Debt

(5) Working Capital to Total Assets

These ratios were chosen for examination primarily because they are commonly used in financial statement analysis and are significantly affected by capitalization of executory contracts. Also, a recent and rather extensive empirical study strongly supports the conclusion that of all ratios these five are the best indicators of the failure of firms during a period five years before failure.\(^7\) The study classified ratios into the following groups: (1) Cash Flow Ratios, (2) Net Income Ratios, (3) Debt to Total Asset Ratios, (4) Liquid Asset to Total Asset Ratios, (5) Liquid Asset to Current Debt Ratios, (6) Turnover Ratios (inapplicable here). Each of the five ratios selected above was found to be the most reliable in each of these groups. That is, of some thirty ratios computed for 79 failed companies and 79 comparable nonfailed companies, these five ratios were among the best six (the sixth is inapplicable) on the basis of having the lowest percentage of error in predicting

the failure of firms. The study provides empirical support and verification for the usefulness of financial ratios (and thus, the underlying accounting data) in terms of their predictive ability. In addition, the author of the paper suggests that the study perhaps underestimates the usefulness of the ratios:

If the ratios are used to detect the financial 'illness' of a firm, there may be many firms whose illnesses were detected before failure occurred. In these cases, the proper treatment was applied, and the firms did not fail . . . . An important piece of information is missing—how many firms were saved from failure because their problems were detected in time through the use of ratios? Such information would be difficult, if not impossible to obtain.\(^8\)

The capitalization of executory contracts may improve financial analyses and permit the signs of financial "illness" to appear in the statements at a much earlier date. This point has been made by others in somewhat indirect fashion:

Finally, the balance sheet—as presently constituted—affords an incomplete statement of assets and liabilities. Impending outlays associated with pension obligations, lease agreements, and purchase and construction commitments frequently remain unspecified. To the extent that the omitted items affect the current position, analyses which stress

\(^8\)Ibid., p. 101.
working capital fall even shorter of their mark. 9
Perhaps this quote should be expanded to state that if executory contracts are omitted, not only working capital, but all financial analyses are incomplete.

It should be emphasized at this point that statement users, as noted in Chapter IV, are interested in more than predictions of failure. Relative profitability, managerial effectiveness, growth, and so forth, are of great importance to statement users and can be very significantly affected by executory contracts. Therefore, the present chapter is not testing the usefulness of executory contract data for these types of measures.

The previously mentioned ratios are used in analyzing Sample Manufacturing Company, both before and after capitalization of the following types of executory contracts:

(1) Lease Contract

(2) Purchase Contract

(3) Construction Contract

(4) Stock Options

(5) Labor Contract

Note that the terms and amounts of these contracts have been kept extremely simple for purposes of this illustration. Data on these contracts are given in the next section, followed by entries to record these contracts, together with financial statements before and after capitalization. Both discounted and undiscounted amounts are shown and discussed. It is assumed in this illustration that the effective market rate of interest on all contracts is 4%.

**Recording the Contracts**

**Lease Contract**—The Company leases operating equipment and facilities on a long-term basis. Aggregate rentals for the next 13 years due under the lease amount to $3,000,000 annually. This lease might be recorded as follows: 10

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10 (000 omitted from all amounts in both columns).
Rights to Leased Property

<table>
<thead>
<tr>
<th>Rights to Leased Property</th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>39,000</td>
<td>29,958</td>
</tr>
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</table>

Liability for Leased Property—Current

<table>
<thead>
<tr>
<th>Liability for Leased Property—Current</th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3,000</td>
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</table>

Liability for Leased Property—Long-Term

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>36,000</td>
<td>27,074</td>
</tr>
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</table>

**Purchase Commitments**—Sample Company has interests in various production projects and is required to take its ownership proportion of the products produced from these projects, for which it is committed to pay its proportionate share of the operating costs of these projects, either directly, or as part of the purchase price of the product. The minimum amount which the Company is committed to pay is approximately $3,000,000 annually over the next 15 years, regardless of the quantity of product received. This contract may be capitalized as follows:

<table>
<thead>
<tr>
<th>Purchase Commitments—Current</th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Purchase Commitments—Long-Term</th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>42,000</td>
<td>30,470</td>
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</table>

<table>
<thead>
<tr>
<th>Liability for Purchase Commitments—Current</th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3,000</td>
<td>2,884</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liability for Purchase Commitments—Long-Term</th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>42,000</td>
<td>30,470</td>
</tr>
</tbody>
</table>
Construction Contracts--As of the balance sheet date, the Company has entered into contracts as part of a program for the expansion of major facilities. According to contract terms, facilities costing $10 million will be completed by the end of next year, while another $8 million in facilities will be completed two years from the balance sheet date. The following entry capitalizes these construction contracts.

<table>
<thead>
<tr>
<th></th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction Contracts</td>
<td>18,000</td>
<td>17,012</td>
</tr>
<tr>
<td>Liability for Current Construction Contracts</td>
<td>10,000</td>
<td>9,615</td>
</tr>
<tr>
<td>Liability for Construction Contracts--Long-Term</td>
<td>8,000</td>
<td>7,397</td>
</tr>
</tbody>
</table>

Stock Options--A qualified stock option plan was approved by the shareholders in the current year. As of the balance sheet date, there were outstanding options for 20,000 shares at $125 per share, all of which were exercisable. The Company's experience indicates that 2,000 shares will be exercised during each of the ten succeeding years, at an annual value of $250,000. The contract is recorded as follows:
<table>
<thead>
<tr>
<th></th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivable from Stock Options--</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>250</td>
<td>240</td>
</tr>
<tr>
<td>Receivable from Stock Options--</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term</td>
<td>2,250</td>
<td>1,788</td>
</tr>
<tr>
<td>Stock Under Option</td>
<td>2,500</td>
<td>2,028</td>
</tr>
</tbody>
</table>

**Labor Contract**—In December of the current year, Sample negotiated a three-year labor contract with its employees. Under the terms of the contract, $33 million annually in wages are guaranteed to the employees. Employees are paid their actual earnings each pay period, the guarantee coming into effect only when earnings drop below the predetermined minimum of $33 million annually. The following entry illustrates how this contract might be recorded.

<table>
<thead>
<tr>
<th></th>
<th>Undiscounted Amounts</th>
<th>Discounted Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor Guaranteed Under Contract--</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>33,000</td>
<td>31,729</td>
</tr>
<tr>
<td>Labor Guaranteed Under Contract--</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term</td>
<td>66,000</td>
<td>59,846</td>
</tr>
<tr>
<td>Liability for Guaranteed Wages--Current</td>
<td>33,000</td>
<td>31,729</td>
</tr>
<tr>
<td>Liability for Guaranteed Wages--Long-Term</td>
<td>66,000</td>
<td>59,846</td>
</tr>
</tbody>
</table>
On the following pages, the financial statements for Sample are shown. The income statement is unchanged as a result of the capitalization of executory contracts. Also presented is the balance sheet for Sample before capitalization of contracts and after capitalization of contracts, using both discounted and undiscounted amounts. A tabulation of ratios computed before and after capitalization of executory contracts follows the income statement.

**Working Capital**

Working capital decreased $12,750, or approximately 20% (from $63,621 down to $50,871), as a result of the capitalization of the five executory contracts mentioned previously. This net decrease can be attributed to the recognition of current liabilities for lease payments ($3,000), and current payments to come due for construction in the next period ($10,000). This decrease of $13,000 in working capital was offset by an increase in working capital from stock options receivable ($250). In terms of a funds statement, there is an additional source of working capital of $250 and an additional use of funds of $13,000. The purchase contract and labor contract do not affect working capital.
SAMPLE MANUFACTURING COMPANY
BALANCE SHEET
as of December 31, 196X
(o00 omitted)

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Before Capitalization</th>
<th>After Capitalization (Undiscounted)</th>
<th>After Capitalization (Discounted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>$102,177</td>
<td>$102,177</td>
<td>$102,177</td>
</tr>
<tr>
<td>Purchase Commitments--Current</td>
<td></td>
<td>3,000</td>
<td>2,884</td>
</tr>
<tr>
<td>Receivable from Stock Options--Current</td>
<td></td>
<td>250</td>
<td>240</td>
</tr>
<tr>
<td>Labor Guaranteed Under Contract--Current</td>
<td></td>
<td>33,000</td>
<td>31,729</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$102,177</td>
<td>$138,427</td>
<td>$136,970</td>
</tr>
<tr>
<td>Investments</td>
<td>$27,030</td>
<td>$27,030</td>
<td>$27,030</td>
</tr>
<tr>
<td>Purchase Commitments--Long-Term</td>
<td></td>
<td>42,000</td>
<td>30,470</td>
</tr>
<tr>
<td>Property, Plant &amp; Equipment</td>
<td>137,590</td>
<td>137,590</td>
<td>137,590</td>
</tr>
<tr>
<td>Rights to Leased Property</td>
<td></td>
<td>39,000</td>
<td>29,950</td>
</tr>
<tr>
<td>Other Long-Lived Assets:</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Construction Contracts</td>
<td></td>
<td>18,000</td>
<td>17,012</td>
</tr>
<tr>
<td>Receivable from Stock Options--Long-Term</td>
<td></td>
<td>2,250</td>
<td>1,788</td>
</tr>
<tr>
<td>Labor Guaranteed Under Contract--Long-Term</td>
<td></td>
<td>66,000</td>
<td>59,846</td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>$266,797</td>
<td>$470,297</td>
<td>$440,724</td>
</tr>
</tbody>
</table>
### LIABILITIES AND STOCKHOLDERS' EQUITY

<table>
<thead>
<tr>
<th></th>
<th>Before Capitalization</th>
<th>After Capitalization (Undiscounted)</th>
<th>After Capitalization (Discounted)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability for Leased Property—Current</td>
<td>$38,556</td>
<td>$38,556</td>
<td>$38,556</td>
</tr>
<tr>
<td>Liability for Purchase Commitments—Current</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability for Construction Contracts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability for Guaranteed Wages—Current</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>total current liabilities</td>
<td>$38,556</td>
<td>$87,556</td>
<td>$85,668</td>
</tr>
<tr>
<td><strong>Long-Term Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability for Leased Property—Long-Term</td>
<td>$23,431</td>
<td>$23,431</td>
<td>$23,431</td>
</tr>
<tr>
<td>Liability for Purchase Commitments—Long-Term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability for Construction Contracts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability for Guaranteed Wages—Long-Term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>total long-term liabilities</td>
<td>$23,431</td>
<td>$175,431</td>
<td>$148,218</td>
</tr>
<tr>
<td><strong>total liabilities</strong></td>
<td>$61,987</td>
<td>$262,987</td>
<td>$233,886</td>
</tr>
<tr>
<td><strong>Common Stock</strong></td>
<td>$102,728</td>
<td>$102,728</td>
<td>$102,728</td>
</tr>
<tr>
<td><strong>Stock Under Option</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Retained Earnings</strong></td>
<td>$102,082</td>
<td>$102,082</td>
<td>$102,082</td>
</tr>
<tr>
<td><strong>total stockholders' equity</strong></td>
<td>$204,810</td>
<td>$207,310</td>
<td>$206,838</td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</strong></td>
<td>$266,797</td>
<td>$470,297</td>
<td>$440,724</td>
</tr>
</tbody>
</table>
SAMPLE MANUFACTURING COMPANY
Income Statement
for the year ended December 31, 196X
(ooo omitted)

SALES AND REVENUES:

Net Sales $268,804
Other Revenues 3,232
$272,036

COSTS AND EXPENSES:

Cost of Goods Sold $199,166
Depreciation, Depletion and Amortization 13,232
Selling and Administrative Expenses 23,745
State, Local and Miscellaneous Taxes 5,990
Interest and Other Costs on Long-Term Debt 1,296
U.S. and Foreign Income Taxes 12,126
$255,555

NET INCOME for the year $16,481
### TABLE III

**TABULATION OF WORKING CAPITAL AND RATIOS COMPUTED**

<table>
<thead>
<tr>
<th>Computation or Ratio</th>
<th>Before Capitalization</th>
<th>After Capitalization (Undiscounted)</th>
<th>After Capitalization (discounted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working Capital (in millions)</td>
<td>$63.6</td>
<td>$50.9</td>
<td>$51.8</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>2.7</td>
<td>1.6</td>
<td>1.6</td>
</tr>
<tr>
<td>Debt to Equity</td>
<td>.30</td>
<td>1.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Debt to Total Capital</td>
<td>.23</td>
<td>.56</td>
<td>.51</td>
</tr>
<tr>
<td>Rate of Return on Investment</td>
<td>.06</td>
<td>.034</td>
<td>.039</td>
</tr>
<tr>
<td>Cash Flow to Total Debt</td>
<td>.47</td>
<td>.11</td>
<td>.14</td>
</tr>
<tr>
<td>Working Capital to Total Assets</td>
<td>.23</td>
<td>.11</td>
<td>.12</td>
</tr>
</tbody>
</table>
since they add equal amounts to current assets and current liabilities.

**Current Ratio**

Similarly, the current ratio decreased from 2.7 to 1 ($102,177/$38,556), to 1.6 to 1 ($138,427/$87,556), as a result of giving recognition to the five executory contracts. The significance of this ratio may improve considerably since the 1.6 to 1 seems to represent a more realistic measure of the firm's ability (or perhaps inability) to pay its short-term debts. The decrease is due mainly to the recognition of current liabilities for lease contracts and construction contracts. These liabilities will definitely come due in the succeeding period and thus, have been appropriately accounted for and included in the financial statements. Other factors which contributed to the lowering of the current ratio were the addition of purchase commitments and labor contracts (total $36,000), to both current assets and current liabilities. Additions of equal amounts to current assets and liabilities (when original amounts are unequal) has the effect of lowering the ratio.
Debt to Equity Ratio

The debt to equity ratio has undergone drastic changes in the process of capitalizing executory contracts. Prior to capitalization, the ratio was 0.30 to 1 ($61,987/$204,810). After capitalization the same ratio increased to 1.3 to 1 ($262,987/$207,310). This change was due to the tremendous impact on short and long-term debt, of lease, purchase, construction, and guaranteed annual wage contracts—a total increase in liabilities of $201,000. A creditor who omits any of these contracts from his calculations to determine ability to repay short or long-term debt, is seriously misled.

Debt to Total Capital

This ratio is designed to yield the same information as the debt to equity ratio. Prior to capitalization the ratio was 0.23 ($61,987/$266,797). This, of course, indicates that creditors are supplying 23% of the total capital of the Company. After capitalization the ratio increased to 0.56, indicating that creditors are, in reality, supplying 56%, rather than 23% to the Company's total capital.
Rate of Return on Investment

Rate of return on investment is lowered considerably after capitalization of executory contracts. Sample Company had a net income, after taxes, of $16,481 for the year. Relating this income to the asset bases, before and after capitalization, yields rates of return of 6% ($16,481/$266,797), and 3.4% ($16,481/$470,297), respectively. The decreased rate of return is due to the addition of $203,500 to the asset base.

Some may question whether or not executory contracts contribute to the production of earnings in the same manner as other assets. It may be argued that, in the same way that only a part of the total service potential of a building or inventory is used in any one period, so also, only a part of the total service potential of a labor contract or lease contract or any other executory contract, is used in one particular period. Thus, contracts may be as legitimate a part of the asset base, in computing conventional rate of return, as any other asset. In fact, if one defines an asset as rights to expected future service potentials or future economic benefits, it may be somewhat meaningless to
capitalize partially completed construction and ignore other executory contracts. For example, a building which is 10% complete under contract, and 10% of which has been paid for, is capitalized as an asset to the extent payment has been made. The present service potential of 1/10th of a building is nil, since it cannot be used in the production process. Following this line of reasoning, it might be concluded that, in terms of direct production of revenues, there is no more justification for capitalizing a partially completed building than there is for capitalizing a completely executory building contract. This argument might be explored further before continuing with a discussion of the other ratios.

On most contracts, the obligation is easily seen, since it must be discharged by monetary means. But, it is difficult to see how the asset simultaneously acquired is used in the production of revenue, since the total service potential is not available for use and in some cases the related asset object of the executory contract does not exist. However, it should be pointed out that a certain minimum asset base is required to generate revenues. Also, most assets must be purchased in quantities larger than those needed for current operations. Thus, executory
contracts may not have contributed directly to past earnings, even though they do contribute indirectly and will certainly contribute to future earnings—else no asset is present.

As some have advocated, perhaps this difficulty can be overcome and the rate of return calculation made more meaningful by computing rate of return on assets employed or used. Such a computation would dictate that most executory contracts, partially completed construction, inventory beyond a minimum needed for operation, excess cash, prepaid expenses and the like, be excluded from the asset base. It is important to note that, with respect to the rate of return calculation, leases differ from most other executory contracts, since they are used in the production of revenue and can be legitimately considered a part of the asset base.

There is the additional problem that firms with no executory contracts have a higher rate of return than those which have such contracts. In view of this and the previously mentioned problems, it becomes difficult to interpret

the meaning of this ratio, if executory contracts are included in the asset base. Thus, a way to partially reconcile these problems is to relate earnings to average assets used for a period.

**Cash Flow to Total Debt**

Cash flow is often defined by financial analysts as net income plus depreciation, depletion and amortization. This was the definition of the ratio as used by Beaver.\(^{12}\) This ratio purports to be a measure of the firm's ability to generate cash with which to discharge debt. In fact, of all the ratios studied by Beaver, the cash flow to total debt was found to be the best indicator of financial failure or "illness." Prior to capitalization, this ratio was .47 for Sample Company ($29,448/$61,978). After capitalization, the ratio decreased considerably to .11 ($29,448/$262,978). The decrease resulted from the recognition of additional debt of $201,000. Essentially, cash flow is a measure of the total funds available to the firm as a result of operations during a period, which can be used for asset expansion.

\(^{12}\)Beaver, *op. cit.*, p. 78.
or replacement, reduction of debt, dividend payments or working capital increased. This ratio, in turn, gives some indication of the firm's ability to reduce debt on the basis of the cash flowing into the business from the firm's operations. If meaningful in the first place, the ratio may be improved by capitalization of executory contracts since, while cash is not affected, the increases in debt after capitalization do, in fact, have to be paid in the same manner as all other liabilities reflected on Sample's balance sheet prior to capitalization. On the other hand, while the numerator (cash flow) covers a one-year period of time, the denominator covers several years. Thus, even though this illustration has been restricted to testing five ratios, it may be worth mentioning that it may be more useful to relate cash flow to current debt before and after capitalization of executory contracts. If these calculations were made, the ratio would drop from .76 ($29,448/$38,556) to .34 ($29,448/$87,556). Again, if this ratio is meaningful without executory contracts, it would appear to be a more accurate ratio after capitalization, since additional current debt is included.
Working Capital to Total Assets

This ratio decreased from .23 ($63,631/$266,797), before capitalization to .11 ($50,781/$470,297) after capitalization. Both the numerator and denominator have changed in this ratio, i.e., working capital decreased $12,840, while total assets increased $203,500. The ratio is presumed to indicate excesses or deficiencies in working capital relative to total assets.

Analysis by Short-Term Creditors

It certainly seems that 1.6 to 1 (current ratio after capitalization) is a more realistic or better measure of the current ratio. A short-term creditor or potential short-term creditor should recognize that:

(1) the guaranteed annual wage contract in the amount of $33 million must be paid in the current year,

(2) the purchase commitment required the purchase of $3 million (minimum) in raw materials during the coming year,

(3) the lease payments in the amount of $3 million
annually must be paid, and

(4) the construction contract in the amount of $10 million for the coming year, for which no outside financing arrangement has been made yet, will have to be paid.

Any creditor who omits these items from his analysis is overstating Sample's current debt-paying power.

It might be asked why executory contracts, which have no effect on working capital, should be capitalized. In other words, in the example under consideration, three contracts have an effect on working capital, while the other two contracts do not affect working capital. For example, capitalization of the lease contract resulted in additional long-lived assets of $39,000, a current liability of $3,000 and long-term liabilities of $36,000. Capitalization of the construction contract added $18,000 to long-lived assets, $10,000 to current liabilities and only $8,000 to long-term liabilities. The stock option contract added $250 to current assets, $2,250 to long-lived assets and $2,500 to stockholders' equity. Therefore, the net effect, as mentioned earlier, has been a decrease in working capital of $12,750. In contrast, the purchase contract and labor
contract add equal amounts to current assets and current liabilities and equal amounts to long-lived assets and long-term debt (thus, no effect on working capital). However, the advantage of capitalizing these amounts is that the current ratio is altered and hence, current debt-paying ability is changed considerably. In addition, the reader is made aware of the asset value and liability value of both the service potentials acquired under these contracts, as well as those given up in the contracts. Also, the reader of the statement is told that the Company has taken steps to secure its supply of raw materials or perhaps that management has taken advantage of a favorable price by forward buying. Also, the reader is informed, as a result of the appearance of the labor contract, that operations are less likely to be interrupted by strikes over wage demands. As was noted earlier, guaranteed annual wages must be paid, regardless of the work performed by employees, and payments must be made under the purchase contract, regardless of the quantity of product received. Thus, these contracts can be considered as liabilities, and their reporting satisfies the important objective of depicting the overall debt pattern of the Company—both short and long-term.
Analysis by Long-Term Creditors and Investors

If executory contracts are treated as assets and liabilities, creditors are supplying a much larger portion of the Company's total assets. The debt to equity ratio, it will be recalled, rose from 33% to 140%, while the debt to total assets ratio rose from 23% to 56%. These are rather drastic changes. However, these figures must only be compared with those of other companies that have also capitalized their executory contracts. If companies make it a practice to capitalize executory contracts, entirely new guidelines will develop with respect to the appropriate or desirable proportions of debt and equity which companies in particular industries should be carrying. A point to be made is that financial ratios, after capitalization of executory contracts seem to represent a more complete description of the total obligations of the company and incorporate obligations, which might take several years to appear or for investors and creditors to become aware of, under conventional accounting procedures. The increases in ratios relevant to investors and creditors are caused by recognition of long-term liabilities for leases, purchase
commitments, construction contracts and guaranteed annual wages. It is not difficult to accept that, since these obligations will have to be paid in the future (if the going concern is accepted), ratios which include these obligations might be more meaningful.

Funds Statement

It might also be meaningful to incorporate executory contracts into a funds statement if a broad approach, similar to that recommended by Perry Mason in Accounting Research Study No. 2, is taken to the concept of "funds." In recommending this broad approach, Mason suggests that, in its most useful meaning, the term "funds":

... is conceived of as purchasing or spending power, or as all financial resources, arising ... from external rather than internal transactions of the business enterprise. In other words, it extends the concept to include assets or financial resources which do not affect or flow through working capital accounts.

... The narrower definitions, such as cash or working capital, have often led to the omission from the statement of the effect of transactions which do not directly affect cash or working capital, but which nevertheless are important items in the
financial administration of the business.\textsuperscript{13}

A funds statement which had been constructed for Sample Company on this basis, prior to the capitalization of executory contracts, would require that the following items be added after capitalization:

**Additional Sources of Funds:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in working capital from executory contracts</td>
<td>$36,250</td>
</tr>
<tr>
<td>Increase in long-term executory contracts (liabilities)</td>
<td>152,000</td>
</tr>
<tr>
<td>Increase in stock options</td>
<td>2,500</td>
</tr>
</tbody>
</table>

**Additional Uses of Funds:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease in working capital from executory contracts</td>
<td>$49,000</td>
</tr>
<tr>
<td>Increase in long-lived executory contracts (assets)</td>
<td>167,250</td>
</tr>
</tbody>
</table>

**Net Decrease in Funds from Executory Contracts** $25,500

When the above transactions are included in the type of funds statement suggested by Mason, the statement becomes more meaningful in terms of its objective. That objective is to report the effect of non-cash, or non-working capital transactions which are important items in the financial

administration of the business. Certainly, entering into these executory contracts are important transactions of this type and the funds statement may be a vehicle for reflecting these transactions in a meaningful manner. The format of the statement could, of course, be varied to emphasize certain transactions. For example, instead of showing increases in long-term executory contracts (liabilities) in one total ($152,000), the following individual items could be reflected:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase in Leased Property</td>
<td>$ 36,000</td>
</tr>
<tr>
<td>Increase in Purchase Commitments</td>
<td>42,000</td>
</tr>
<tr>
<td>Increase in Construction Contracts</td>
<td>8,000</td>
</tr>
<tr>
<td>Increase in Guaranteed Wage Contracts</td>
<td>66,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$152,000</strong></td>
</tr>
</tbody>
</table>

This type of funds statement could be a vehicle for summarizing the effect of all executory contracts, or for isolating and emphasizing certain of these contracts.

**Separate Schedule for Executory Contracts**

A separate schedule may be used for communicating information on executory contracts to users of published reports. The schedule has very strong appeal as a reporting vehicle when one considers: (1) that footnote disclosure alone appears to be inadequate, and (2) the difficulties created by capitalization of such contracts. The schedule
on the next page was suggested by Zises.\textsuperscript{14} Such a schedule may accomplish a reporting result which neither capitalization nor footnote disclosure could accomplish alone. In addition, the existing body of accounting concepts and principles need not be changed or revolutionized in any way. In fact, current generally accepted accounting principles permit disclosure of executory contracts in separate schedules, so as to prevent statements from being misleading. The schedule allows for quantification and verbal description in schedule footnotes, and yet prominently displays and summarizes the total effect on the firm of all material transactions involving executory contracts.

**Possible Correlation Analysis**

Perhaps executory contracts can be used in correlation analyses as leading indicators of the future costs, revenues and earnings of the firm. By reporting executory contracts and having them covered by the auditor's opinion, objective data are provided which can, in turn, be utilized with much

Schedule of Material Contractual Commitments (S-X Rules 3.18 and 3.19)

<table>
<thead>
<tr>
<th>Type of Commitment</th>
<th>Amount Paid this Year</th>
<th>Amounts Contracted or Estimated for Each of Next 5 Years and for Each of Three 5-Year Periods Beyond</th>
<th>Minimum Amount of Commitment if Determinable*</th>
<th>Remaining Period (yrs.) from Date of Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase and Repurchase for:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Fixed Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Inventory and Supplies</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Other</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term Leases</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalties</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension and Retirement</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee Contracts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guarantees</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contingent Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other (Explain)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*The minimum balance payable, in each type of commitment, may be discounted over the remaining period by a stated per annum percentage. Where such minimum balance is discounted, state the percentage used in each case.

Where amounts both paid and payable for any type of commitment are not material, a statement to that effect for any such type of commitment will suffice. Show amounts separately for each type of commitment if amounts paid or payable are material.

Any pertinent information of a material nature regarding any commitment should be furnished within footnotes to the schedule.
more confidence and success by management and financial analysts to predict future prospects for users of published annual reports. For example, inventory and labor are two of the most important costs in most firms and industries. Very often, these are purchased in advance by contract, with the prices of these resources fixed under the contract. In the case of retailing firms, purchase commitments very often can be strongly correlated with sales, and can serve as leading indicators of future sales. In retail firms, such as Sears Roebuck, Safeway and similar firms, the relationship of the number of stores to sales volume, is probably direct. In the case where leases are substituted for store ownership, perhaps leases can be correlated with sales volume. Actual correlations are, however, beyond the scope of this study. The possibility of generating the above type data suggests that perhaps executory contracts might be most meaningful when presented in separate schedules or statements.

**Substitution of Assets and Liabilities**

It can be argued that some executory contracts are more or less permanent substitutes for assets and liabilities and, so should be recorded in the accounts. Considering
the contracts under discussion in the illustration, the lease contract and purchase contract fall into this category. In the case of leasing, instead of owning the property, which would require the issuance of long-term debt obligations or equity, the firm substitutes lease contracts. If the lease contract is not capitalized as an asset and corresponding liability, operating assets and their related liabilities are permanently omitted from the balance sheet. The case of purchase commitments is somewhat similar. In other words, instead of carrying a three-year supply of inventory, the firm may enter into a three-year purchase contract. Or, perhaps, to take advantage of a favorable price, or to guarantee the availability of a supply of raw material, the firm purchases merchandise under contract rather than issuing stock or debt to finance the acquisition of a three-year supply. The three-year supply may even represent a permanent increase in inventory and therefore, a permanent increase in working capital.

There are significant trends toward contract buying in many industries, which cause several problems of comparability in financial statements. A recent survey indicates the increased use of long-term purchase contracts for
buying inventory. Contract buying has nearly doubled in the last five years. The survey contacted more than two hundred firms in twenty-one different industries. The results indicated that 95% of the purchasing agents contacted used long-term buying agreements. Of this 95%, 12% of the respondents negotiate purchase contracts up to six months in length, 71%, up to a year in length, and 17%, longer than a year in length. Many of these contracts have the effect of shifting inventory to the suppliers. For example, United Airlines has shifted more than $2 million in inventory (food and liquor items) to its suppliers through contract buying. This increased buying on contract creates problems in the area of comparability of financial statements. First, some companies buy on contract, while others do not. Ideally, identical companies should carry nearly identical amounts of inventory. It might be revealed by capitalizing purchase commitments that, where one company carries larger inventories, another carries much smaller


inventories, but larger purchase commitments. In sum, pur­
chase contracts can significantly affect the minimum amounts
of inventory a firm must carry.

Inventory turnover can be increased considerably by
utilizing purchase contracts. Instead of carrying larger
permanent inventories, purchase contracts are used to shift
the inventory to suppliers and lower the average amount of
inventory carried, thus increasing inventory turnover, some
times artificially, as compared to other companies.

Companies may also be investing in inventory by buy­
ing under long-term purchase contracts, covering a period of
time longer than that necessary so as to carry minimum inven­
tories. In effect, this procedure amounts to speculation
in inventory or investing in purchase contracts. The
transaction is comparable to the purchase of land as an
investment or for future use. Users of published annual
reports should be made aware that such investments have been
made, since they certainly use up the limited borrowing
power of any firm. Also, in the case of purchase commit­
ments, which are security for long-term debt, and under which
payments must be made even though no inventory is received,
the essence of the transaction can be made known to users
via capitalization of the purchase contract. The nature of this almost "sham" transaction should be brought to the attention of the reader by reporting of the purchase commitments. Full recognition of the liability may be made, and possibly some downward valuation of the asset shown, to indicate the probability of payments having to be made, even though no asset is received, or the asset received has declined in market value.

In looking at a series of statements after capitalization of executory contracts, it may be possible to note increasing substitutions of purchase commitments for inventory, and leases for fixed assets. Perhaps indices such as:

<table>
<thead>
<tr>
<th>Purchase Commitments</th>
<th>Lease Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory Carried</td>
<td>Fixed Assets</td>
</tr>
</tbody>
</table>

will reveal such shifts. For Sears Roebuck & Company, the purchase index was as follows for the years indicated:

<table>
<thead>
<tr>
<th>Year</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>0.81</td>
</tr>
<tr>
<td>1955</td>
<td>0.98</td>
</tr>
<tr>
<td>1960</td>
<td>1.11</td>
</tr>
<tr>
<td>1961</td>
<td>1.14</td>
</tr>
<tr>
<td>1962</td>
<td>1.12</td>
</tr>
<tr>
<td>1963</td>
<td>1.16</td>
</tr>
<tr>
<td>1964</td>
<td>1.18</td>
</tr>
<tr>
<td>1965</td>
<td>1.25</td>
</tr>
<tr>
<td>1966</td>
<td>1.33</td>
</tr>
</tbody>
</table>

If this index could be correlated with the turnover of
inventory for the same years, it might indicate why inventory turnover has increased, and probably would also show that Sears is carrying an increasing proportion of their inventory in purchase commitments. Unfortunately, cost-of-goods sold data are not available in Sears' annual report.

The substitution of lease contracts for assets has been generally recognized. Gant points out very well, the idea that leases are merely a method of financing the acquisition of assets by means other than conventional debt or equity issues:

Out of these inadequacies has come a curious sort of logic which argues that the existence of an asset can be determined or denied by a ledger entry, and that a promise to pay becomes an obligation only if it is reflected in figures on a balance sheet.

This sort of rationalization may serve to ease the conscience of a management that is opposed to debt, or that has seen the amount of its debt climb to a disturbing level, but, unfortunately, it ignores certain basic economic facts of life. Every business requires certain fixed assets, and the choice available to it is not whether to finance these assets but how to finance them. Lease financing is one way of acquiring assets, but, it is a form of borrowing . . . .

Like all types of borrowing, lease obligations draw on the credit of the borrower, and credit is not a bottomless well. If it is used in one form, it is not available to be used again in
The lease should be looked upon in the same way as a bond or other form of long-term debt. The following lists from Nelson reveal the similarities of bond and lease obligations.

**Lease**

1. Leasing is a source of capital.

2. Lease requires periodic payments for a fixed period of time. These payments contain two elements:
   (a) Return of investment.
   (b) Return on investment.
   (Since the lease is normally 'net,' the return can be calculated at a fixed rate in advance.)

3. Leases often contain a 'rejectable offer' clause which enables the leasee to 'retire' the lease early.

4. The primary security behind the lease is normally the general credit of the lessee rather than the value of the leased property.

**Bond**

1. Bonds are a source of capital.

2. Bonds require periodic payments for a fixed period of time. These payments contain two

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elements:
(a) Sinking fund payment or a serial maturity (return of investment).
(b) Periodic interest (return on investment).
   This return can be calculated at a fixed rate in advance.

3. Bonds often contain a 'call' provision which gives the borrower the right to retire them prior to maturity.

4. The primary security behind a bond issue is also the general credit standing of the borrower. Mortgage of pledged property is only of secondary importance.  

Nelson has also made rather extensive calculations (in Chapter 6) to show the impact, on fourteen financial ratios, of the result of capitalization of leases for eleven companies. These ratios are affected substantially and, "in all instances (where the ratios themselves are meaningful) the ratios are made more meaningful by capitalization."  

It is submitted that the increase in information resulting from lease capitalization may also result from the capitalization of other types of executory contracts. But,


19Ibid., p. 93.
before recommending capitalization of executory contracts on the basis of more meaningful financial ratios, considerable additional research will have to be conducted, which should be aimed at investigating other types of ratios and capitalization procedures. In addition, other methods for communicating information on executory contracts, by means other than capitalization (such as supplementary schedules), seem to be very worthy of additional investigation.
CHAPTER VII

SUMMARY

The problem of accounting for executory contracts is receiving increased attention, primarily because of the current controversy over leases. It is thought by some that capitalization of lease contracts may also require that other types of executory contracts be capitalized. The same principles applicable to leases may, in fact, be applicable to other executory contracts. Recent literature indicates that the accounting profession is becoming increasingly aware of the problem posed by executory contracts. The American Institute of Certified Public Accountants, Accounting Research Study No. 4, and the American Accounting Association all have recognized the existence of the problem posed by executory contracts as well as the need to study it.¹ In investigating the

¹Accounting Principles Board, Reporting of Leases in Financial Statements of Leases, Opinion No. 5 (New York: American Institute of Certified Public Accountants, September, 1965), pp. 29-30. See also, John H. Myers, Reporting of Leases in Financial Statements, Accounting Research Study
problem this study has attempted to accomplish five major objectives:

(1) To determine the present theoretical treatment of executory contracts and to trace the development of this theory.

(2) To examine the adequacy of the current treatment when current generally accepted accounting principles are applied to various types of executory contracts.

(3) To determine the objective of financial reporting and how executory contracts relate to that objective. Essentially this task amounts to determining what constitutes relevant, useful financial information to users of published annual reports and determining the extent to which executory contract data qualifies as such information. This task is accomplished throughout Chapters IV and VI.

(4) To attempt to derive a consistent theoretical foundation to serve as a basis for accounting for executory contracts, if such contracts are to be considered assets and liabilities.

(5) To capitalize executory contracts, so as to investigate the effect of such capitalization on selected financial ratios.

These five objectives were treated in the above order in the preceding six chapters. A summary of each chapter is presented below.

**Historical Development of Current Theory of Executory Contracts**

There are at least two official pronouncements from which some indication can be had, as to what the American Institute of Certified Public Accountants says are generally accepted accounting principles which should be followed in handling executory contracts. Accounting Research Bulletin No. 29 on "Inventory Pricing," issued in July 1949, and subsequently incorporated into Accounting Research Bulletin No. 43, states:

Accrued net losses on firm purchase commitments for
goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement.\textsuperscript{2}

Opinion No. 5 on reporting of leases issued in September, 1965 by the Accounting Principles Board stated that:

The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.

The rights and obligations related to unperformed portions of executory contracts are not recognized as assets and liabilities in financial statements under generally accepted accounting principles as presently understood. Generally accepted accounting principles require disclosure of the rights and obligations under executory contracts in separate schedules or notes to the financial statements if the omission of this information would tend to make the financial statements misleading.\textsuperscript{3}

These two official pronouncements regarding executory contracts are probably based upon the writings of early authors

\textsuperscript{2}Committee on Accounting Procedure, \textit{Accounting Research Bulletin No. 43} (New York: American Institute of Certified Public Accountants, 1953), p. 34.

such as Sprague, Kester, Canning and Montgomery. Just as the above principles are framed, almost entirely, in terms of leases and purchase commitments, so also, these early writers were concerned, almost exclusively, with leases and purchase commitments. The accounting principles recommended by early writers and those enunciated in the above quotes, are both heavily influenced by the legal concepts of assets, liabilities, title transfer, and performance, rather than by economic concepts. In addition, it might be said that the current position of the accounting profession with respect to executory contracts is almost identical with that of writers, as far back as Sprague. In this sense, little progress has been made with accounting concepts and principles for treating executory contracts. At the same time, the accounting profession has always recognized that information on executory contracts is highly relevant financial information, which often must be presented to users of financial statements to prevent their being misled.

Adequacy of Current Theory of Executory Contracts

The modern corporation can be viewed as a "bundle of contracts," which includes contracts, both oral and written,
for the purchase and sale of goods and services, contracts for the lease of both real and personal property, employment contracts, bond contracts and innumerable other contracts which will be encountered in any dynamic business firm. Some of these contracts are recognized as assets and liabilities, others are not. Basically, the generally accepted accounting principles governing the accounting treatment of these contracts, state that unperformed portions of executory contracts are not currently recognized as assets and liabilities in financial statements, but, disclosure of these contracts in footnotes or schedules is required, if their omission would tend to make the statements misleading. The primary criteria for capitalization of contracts is that performance must have taken place.

The adequacy of this principle of extent of performance, as a basis of recognition or nonrecognition of executory contracts, as assets and liabilities, may be questioned, due to the fact that there has never been a comprehensive statement of the concept of performance, and therefore, it seems to have been inconsistently applied as a principle. The lack of a comprehensive definition of the principle and the inconsistency of its application, have
permitted illogical practices to exist, such as recognizing losses on purchase commitments while failing to recognize the purchase commitment as an asset, i.e., recognition of loss on an asset the corporation will not admit exists. If the principle of extent of performance is applied to various contracts (sales and purchase contracts, stock subscription contracts, long-term lease contracts and long-term purchase commitments), the following weaknesses begin to appear.

(1) If a very broad view is taken, probably all activity carried on by a corporation or its agents, can be construed as being performance under an executory contract, if one views a corporation as a "bundle of contracts." Such a concept, could conceivably justify recording assets on the basis of such activity as sales effort, receipt of a sales order, and so forth.

(2) What constitutes performance in an ordinary or economic sense is not necessarily performance in a legal sense, and hence, may not give rise to a legal claim or legal asset. Accountants have applied a legal concept of performance in some cases and an economic or moral concept of performance in others, and in the case of leases the performance concept was not utilized at all. For example,
revenue can be recognized on executory contracts to sell in an established market (such as with gold or silver), despite the fact that legally, no sale has taken place, no asset has been delivered and therefore, no legal performance has occurred. On the other hand, an ordinary contract to purchase inventory is not recognized in the accounts because legal performance (delivery of assets) has not taken place.

(3) Performance is an activity that often spans a very long period of time, i.e., not often is it begun and completed in an instant. Thus, the problems of measuring extent of performance and determining when substantial performance has taken place must be dealt with.

(4) What constitutes performance under a contract is not clear. Very often delivery of assets has been considered to be the essential part of performance. However, on contracts, for example, where oil is purchased for a twenty year period, can the seller of the oil be considered to have fully performed, if the only additional performance required of him is to turn a valve and let the oil flow? Or, perhaps the seller only performs as the oil is drained from the well. Possibly delivery is not the most important criteria for judging performance but rather that activity
which gives rise to the **right** to delivery.

(5) Performance, in and of itself, does not necessarily give rise to assets in the economic sense. One can perform under a contract and receive nothing of economic value. Thus, perhaps the concept should not be used to determine the acquisition of assets by the firm. Whether or not an asset is acquired, is dependent upon the definition of assets utilized.

(6) The concept of performance can have several dimensions. There are many qualifying adjectives which can be used in conjunction with it, i.e., physical performance, economic performance, legal performance, substantial performance. The concept may even have a time dimension. Accountants have never been clear as to what particular concept was being used.

(7) Last, and most important, the concept of performance, as it has been applied, does not seem to lead directly to the function and purpose of accounting, but rather has been used only to fulfill the requirements of the law.

The preceding discussion of weaknesses supports the conclusion that the performance concept, as presently defined
and understood, is an inadequate theoretical basis for the recognition or nonrecognition of executory contracts as assets and liabilities. Instead of examining executory contracts in light of the legal concept of performance, they must be examined in light of the overall objectives of accounting and financial reporting. Secondly, at what point do executory contracts give rise to assets and liabilities which should be reported to users of financial statements? Whether assets and liabilities arise under executory contracts is a definitional problem. The conception of assets and liabilities used by the accountant is, in turn, dependent upon the objectives he is trying to achieve with financial statements. In sum, the solution to the executory contract problem lies in a determination of whether or not the rights and obligations which arise under executory contracts, give rise to assets and liabilities which it would be useful to report to users of published financial statements.

Thus, a well-formulated theory of executory contracts requires that executory contracts be related to the overall objectives of accounting, and the means or principles of accomplishing these objectives.
Relevant, Useful Information to Users of Published Financial Statements

The AAA Statement has very concisely stated the definition of accounting, "as the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information." Thus, it might be said that the basic objective of financial reporting, is to communicate to the interested, external user, those elements of economic or financial information vital to his purpose or necessary to his decision. The usefulness of data in satisfying users' needs, is the controlling factor dictating the information which should be reported.

The usefulness of accounting information lies in its ability to reduce the uncertainty present in the decisions facing users. The AAA Statement has put forth standards by which to judge the usefulness of accounting information for this purpose. Adherence to the standards of

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relevance, verifiability, freedom from bias, and quantifiability should reduce this uncertainty, and thus, serve as a guide for determining which information should be included or excluded from external accounting reports. These same standards may also be used in judging the usefulness of data on executory contracts. Further, the Committee to Prepare a Basic Statement of Accounting Theory has stated that many executory contracts, not presently reported in financial statements, meet these standards as well as other data reported currently. Generally, the AAA Statement recommends increased reporting of executory contracts where they meet the above standards, particularly the relevance standard. Specifically, the AAA Statement recommends the reporting of all long-term leases, material and nonrepetitive purchase commitments, pension plans, executive compensation contracts, including stock options, deferred compensation contracts and so forth.

Admittedly, relevance to users' needs should be the primary criterion for determining the usefulness of accounting information. However, there may be difficulty in establishing the relevance of, not only data on executory contracts, but also, any accounting data, including that currently reported. At least it is difficult to establish relevance
to a decision in a scientific manner, since to do so, requires that any data be related to actual users decisions models. Such a task has several difficulties, especially for a study on executory contracts. First, most users do not know their needs, or are themselves, not familiar with their own decision models. Second, the informational needs of users are heavily influenced by data that has been previously reported, i.e., users become accustomed to, and learn how to use, only data that has been available previously. Third, the accounting profession has not to date, scientifically derived or defined the decision models of even the major users, such as creditors and investors. Fourth, the task of scientifically formulating users decisions models is a mammoth undertaking and certainly has no place in the context of the present study. At the same time, knowledge of users' decision models is an important element in formulating a theory of executory contracts.

Because of these difficulties, the study is forced to relate executory contracts to a general information system currently advocated by some writers, which is aimed at satisfying what has traditionally been considered to be the decision models of users. This limitation should be
clearly understood. In this study, the traditional, present or existing and somewhat general decision models of external users are accepted, and no attempt is made to prove or disprove these models, nor to derive new, and different models.

By employing ratio analyses, trend analyses and the like, external users evidence an interest in predicting or eliminating some of the uncertainty associated with the following general measurements:

- Costs, revenues and earnings,
- Dividend and market prices of shares,
- Financial position,
- Liquidity and debt-paying ability,
- Growth,
- Fund flows,
- Effectiveness of management

The usefulness of information on important executory contracts, such as leases, various forms of purchase contracts, management employment contracts, guaranteed annual wage contracts and construction contracts was specifically investigated. Unfortunately, it is not possible to cover every type and variety of executory contracts in this study. Future research efforts in this area can investigate other specific contracts in greater detail. The results of this study should be entirely applicable to other types of executory contracts. This investigation supports the conclusion that, perhaps,
most material executory contracts, but certainly those listed above, significantly reduce the uncertainty confronting investors and creditors, in connection with obtaining the general measurements listed above.

In addition, other general conclusions on the usefulness of incorporating executory contract data in financial statements can be drawn from discussions in Chapters IV and VI.

(1) One of the most important of these conclusions has to do with using replacement cost as a valuation method. Full implementation of the concept of replacement cost may require that all executory contracts containing fixed prices (or means of arriving at fixed prices), be recorded in the accounts at the date the contract is negotiated or signed, if holding gains and losses are to be recognized in the proper period. If no asset is recorded until the contract is executed in a succeeding period, there is a presumption that the price paid in this succeeding period is the current price, and all holding gains and losses are recognized in one period (the succeeding period). Holding gains and losses computed on all assets, including executory contracts, can serve as an indicator of managerial effectiveness in
acquiring assets as distinguished from using assets.

(2) Some financial ratios are greatly improved because they incorporate a wider range of data, when executory contracts are recorded in financial statements. The rate of return calculation is made almost meaningless after capitalization of executory contracts. In addition, data are reported at a much earlier date by capitalization, than would be the case if existing reporting practices were followed.

(3) Greater comparability in financial statements is achieved by recording executory contracts, particularly leases and purchase contracts. A firm which leases rather than owning directly, is made comparable to one which owns property. Firms which enter into long-term purchase contracts rather than carrying higher inventories, are equated with firms which carry higher inventories. Firms which enter into long-term purchase contracts, which are used as security for long-term debt, can escape reflecting debt on financial statements. This practice is eliminated by capitalization of purchase contracts. In sum, capitalization of executory contracts as assets and liabilities prevents the substitution of executory contracts for assets and liabilities in
financial statements.

**Theoretical Basis for Capitalization of Executory Contracts**

The usefulness of incorporating executory contracts into financial statements may be demonstrated by relating executory contract data to the various decisions faced by users of these statements. At the same time, however, executory contracts must be theoretically acceptable. Since the function of theory is to describe a wide range of practice, basic accounting concepts and definitions must also accommodate executory contracts, in addition to existing accounting practice. It was shown in Chapter V, that existing asset and liability concepts need only slight modification in order to be applicable to, or descriptive of, executory contracts. These modifications can be achieved primarily through an expansion of two concepts or elements contained in current definitions of assets and liabilities. These two concepts, or elements are: (1) transactions, and (2) rights to service potentials.

The place of these two elements in existing accounting theory is seen in the asset definition suggested by
Sprouse and Moonitz in Accounting Research Study No. 3: "assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction." This same conception of assets as rights to future service potentials, or rights to future economic benefits has been put forth by writers, such as Sprague, Paton and Littleton, Vatter and, more recently, the AAA Committee on Concepts and Standards in their 1957 statement. Traditionally, this asset concept would exclude executory contracts. However, it has been shown in Chapter V that the act of entering into a contract may be considered an accounting transaction on the basis of the fact that: (1) a lease (one form of executory contract) is currently accepted as being a completed transaction, (2) a transaction is most basically an exchange between independent parties (thus, at the time the contract is negotiated or signed, the exchange by the parties to the

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contract, of rights to future service potentials meets the requirements of an accounting transaction), and (3) the act of entering into a contract (unless evidence suggests otherwise) may be a sufficient basis for concluding that assets and liabilities have, in fact, been acquired by the parties to the contract. As a point for recognizing the acquisition of assets and liabilities in connection with executory contracts, the date of entering into the contract may be just as logical, and more useful than are the arbitrary dates now used. As pointed out by Bedford, these dates are: (1) the date title passes, (2) the date goods or services are physically received, and (3) the date cash is paid for goods or services. The recognition of assets and liabilities at the date of entering into the contract, in some cases, can result in a more complete and hence, more informative record of assets and liabilities as presented in financial statements.

In connection with the preceding asset definition, it has been clearly noted that the asset is not the tangible

object which first comes to mind (such as a piece of machinery for example), but rather, the asset is the service potential which can be expected to flow from the tangible object. This becomes more apparent when one considers that intangible assets do, in fact, exist. Or, consider the situation where two firms possess identical pieces of machinery. Assuming the machinery has a market value of zero, it could be considered an asset to the firm that is able to use it (i.e., derive services from it), and not considered an asset by the firm that has no use for it. At the time of entering into the contract, the rights to the service potentials of the object of the contract have been acquired, along with the corresponding obligation to pay for those service potentials. In fact, the rights received under the contract and the rights to the service potentials of the object of the contract, are one and the same set of rights. Thus, when a "contract" is supposedly sold on the market, it must be kept in mind that the contract has no value apart from the object of the contract, or the rights to the services of the object of the contract. If the market price of the contract is above or below the price fixed in the contract, a holding gain or loss has occurred. In
this sense, the contract itself has no value and can be
thought of as a written or verbal description of rights to
future service potentials and therefore, serves as support­
ing evidence that assets and liabilities have been acquired
under the contract.

Once the expanded concept of an accounting transac­
tion is accepted, Sprouse and Moonitz's liability definition
can be utilized in connection with executory contracts, with­
out further qualification. This definition is as follows:

The liabilities of a business enterprise are
its obligations to convey assets or perform
services, obligations resulting from past or
current transactions and requiring settlement
in the future.8

Two other points are worthy of mention in connection
with the concept of future service potentials. First,
since the asset definition does not require that the ser­
vice potentials of the object of a contract (or any other
asset for that matter) be immediately available for use
or consumption by the firm, it might be concluded that
assets can arise under executory contracts prior to the
existence of the object of the contract. For example, a

8Sprouse and Moonitz, op. cit., p. 37.
construction contract might be considered an asset and corresponding liability by the purchaser, even though the building has not yet been constructed under the contract. This may not be too difficult to accept, when one considers that according to generally accepted accounting principles, a purchaser who had paid 1/10 the purchase price of a building upon completion of 1/10 of the contract, would have no qualms about treating the building as an asset to the extent it had been paid for. This treatment is acceptable, in spite of the fact that the immediate availability for use, of the service potential of 1/10 of a building, is nil.

The second point has to do with the question of why stop with capitalization of executory contracts, i.e., why not capitalize all expectations of future service potentials, such as the expected sales for next year. There are several reasons why capitalization should end with executory contracts, at least at the present time. First, the contract serves as concrete evidence, particularly when coupled with the going concern concept, of the fact that the firm has acquired rights to future service potentials (assets). This same type evidence is not available in the
case of other type expectations. Second, the contract serves as concrete evidence that another independent party to the contract has committed himself to the exchange or transaction, and has agreed to do whatever is necessary to fulfill the contract for the acquisition of service potentials. In addition, generally with the formation of the contract, comes the establishment of an objectively determined exchange price for the future service potentials. Such an objective determination of value is not available in the case of simple expectations.

The Effect of Capitalization on Financial Ratios

In Chapter VI, it was stated that replacement cost and price level adjustments can be used in connection with the valuation of executory contracts. No problems are created in using these two valuation techniques for executory contracts, that are not also present in utilizing these techniques for valuation of other assets and liabilities. Hence, the advantages and disadvantages of replacement cost and price level adjustments are not discussed at length.

However, there does seem to be a rather unique advan-

tage in using replacement cost for executory contracts. It
was shown that full implementation of the concept of replace-
ment cost, and hence, holding gains and losses may require
that all executory contracts containing fixed prices (or a
method of fixing prices) be recorded in the accounts at the
date the contract is negotiated. If no asset is recorded
until the contract is partly executed or performed several
periods hence, there is a presumption that the holding
gain occurred in several periods after the negotiation of
the contract. Thus, holding gains and losses are not
recorded in the proper period unless the contract is
recorded in the accounts when negotiated, or unless a
specific adjusting entry is made to take up any holding gain
or loss.

Most of the remainder of Chapter VI, consists of an
illustration of the capitalization of five executory con-
tracts (a lease, a purchase contract, a construction con-
tract, a stock option contract, and a labor contract) and a
discussion of the impact of such capitalization on working
capital and the following five ratios:

(1) Current Ratio
(2) Debt to Equity (and Total Debt to Total Assets)
(3) Rate of Return on Investment
(4) Cash Flow to Total Debt
(5) Working Capital to Total Assets
In some cases, these ratios seem to be improved and made more useful and predictive as a result of capitalization of executory contracts. In addition, capitalization of executory contracts results in a much wider range of data being reported at a much earlier point in time. At the same time, however, executory contracts, other than leases, cannot be recommended for capitalization on the basis of increased usefulness of the ratios studied. The rate of return calculation seems to be meaningless after capitalization of executory contracts. While it cannot be recommended that all executory contracts be capitalized, at the same time, the relevance of executory contract data to users' decisions, seems to be beyond dispute, and therefore, the contract data should be reported in financial statements. Thus, considerable additional research should be conducted, which will investigate other types of contracts, ratios and capitalization procedures. In the meantime, supplementary schedules have strong appeal as a reporting vehicle for executory contracts, when one considers the theoretical and practical difficulties created by capitalization, and the fact that footnote disclosure alone is inadequate.
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VITA

Joseph Frank Wojdak, son of Stephen John and Madelyn Wojdak, was born in Scranton, Pennsylvania, on March 26, 1941. He attended elementary and secondary schools in Scranton and was graduated from Central High School in June, 1958. The following September he entered the University of Scranton, Scranton, Pennsylvania and received a Bachelor of Science degree in 1962. In June, 1964, he received an M.B.A. from the University of Scranton where he served as a teaching assistant for two years.

In June, 1964, he enrolled in the Graduate School of Louisiana State University where he was a teaching assistant until June, 1967. In July, 1967, he joined the faculty at The Pennsylvania State University as Assistant Professor of Accounting and is currently a candidate for the degree of Doctor of Philosophy in Accounting at Louisiana State University. He passed the written examination for the Certified Public Accountant's certificate for Louisiana in May, 1967 and is now satisfying the experience requirement for the certificate.
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Major Field: Accounting

Title of Thesis: An Investigation into the Nature, Theory and Reporting of Executory Contracts

Approved:

[Signatures and titles of people involved in the approval process]

Date of Examination: September 14, 1967