1953

An Analysis of the Traditional Accounting Treatment of Deferred Charges.

James Matthew Owen
Louisiana State University and Agricultural & Mechanical College

Follow this and additional works at: https://digitalcommons.lsu.edu/gradschool_disstheses
Part of the Accounting Commons

Recommended Citation
Owen, James Matthew; 'An Analysis of the Traditional Accounting Treatment of Deferred Charges.' (1953). LSU Historical Dissertations and Theses. 8051.
https://digitalcommons.lsu.edu/gradschool_disstheses/8051

This Dissertation is brought to you for free and open access by the Graduate School at LSU Digital Commons. It has been accepted for inclusion in LSU Historical Dissertations and Theses by an authorized administrator of LSU Digital Commons. For more information, please contact gradetd@lsu.edu.
AN ANALYSIS OF THE
TRADITIONAL ACCOUNTING TREATMENT OF DEFERRED CHARGES

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

James Mathews Owen
A. B., Louisiana College, 1938
M. B. A., Louisiana State University, 1942
June, 1953
MANUSCRIPT THESSES

Unpublished theses submitted for the master's and doctor's degrees and deposited in the Louisiana State University Library are available for inspection. Use of any thesis is limited by the rights of the author. Bibliographical references may be noted, but passages may not be copied unless the author has given permission. Credit must be given in subsequent written or published work.

A library which borrows this thesis for use by its clientele is expected to make sure that the borrower is aware of the above restrictions.

LOUISIANA STATE UNIVERSITY LIBRARY
ACKNOWLEDGEMENT

The writer wishes to express appreciation to Dr. Lloyd F. Morrison, Professor of Accounting, Louisiana State University, for his valuable assistance and guidance in the preparation of this dissertation.

The writer wishes to acknowledge, also, the helpful suggestions made by Dr. W. H. Baughn, Associate Professor of Business Administration, Dr. P. F. Boyar, Professor of Business Administration, Dr. H. L. McCracken, Professor of Economics, and Dr. S. W. Preston, Professor of Business Administration, for improving the original manuscript.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACKNOWLEDGEMENT</td>
<td>11</td>
</tr>
<tr>
<td>ABSTRACT</td>
<td>vii</td>
</tr>
<tr>
<td>I. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>The nature of accounting</td>
<td>1</td>
</tr>
<tr>
<td>Statement of purpose</td>
<td>4</td>
</tr>
<tr>
<td>Organization of this study</td>
<td>6</td>
</tr>
<tr>
<td>II. BASIC ACCOUNTING CONCEPTS</td>
<td>8</td>
</tr>
<tr>
<td>General nature of basic accounting concepts</td>
<td>8</td>
</tr>
<tr>
<td>Utilitarian viewpoint of accounting</td>
<td>11</td>
</tr>
<tr>
<td>Immateriality</td>
<td>11</td>
</tr>
<tr>
<td>Meaningful statement presentation</td>
<td>13</td>
</tr>
<tr>
<td>Objectivity</td>
<td>18</td>
</tr>
<tr>
<td>Consistency</td>
<td>20</td>
</tr>
<tr>
<td>The accounting entity</td>
<td>22</td>
</tr>
<tr>
<td>The accounting period</td>
<td>25</td>
</tr>
<tr>
<td>The going concern concept</td>
<td>26</td>
</tr>
<tr>
<td>Measured consideration</td>
<td>28</td>
</tr>
<tr>
<td>Accounting costs are divisible, mobile, and adhesive</td>
<td>32</td>
</tr>
<tr>
<td>Matching costs and revenues</td>
<td>33</td>
</tr>
<tr>
<td>Conservatism</td>
<td>38</td>
</tr>
<tr>
<td>III. THE NATURE OF THE DEFERRED CHARGES CLASSIFICATION</td>
<td>42</td>
</tr>
<tr>
<td>Deferred charges in the broad sense</td>
<td>42</td>
</tr>
<tr>
<td>CHAPTER</td>
<td>PAGE</td>
</tr>
<tr>
<td>---------</td>
<td>------</td>
</tr>
<tr>
<td>Deferred charges in the limited sense</td>
<td>44</td>
</tr>
<tr>
<td>IV. PREPAID EXPENSES</td>
<td>51</td>
</tr>
<tr>
<td>The nature of prepaid expenses</td>
<td>51</td>
</tr>
<tr>
<td>The detailed accounting procedure for prepaid expenses</td>
<td>52</td>
</tr>
<tr>
<td>Balance-sheet presentation of prepaid expenses</td>
<td>55</td>
</tr>
<tr>
<td>Prepaid interest</td>
<td>62</td>
</tr>
<tr>
<td>V. ORGANIZATION COSTS</td>
<td>66</td>
</tr>
<tr>
<td>The nature of organization costs</td>
<td>66</td>
</tr>
<tr>
<td>The traditional accounting treatment of organization costs</td>
<td>67</td>
</tr>
<tr>
<td>Criticism of the traditional accounting for organization costs</td>
<td>70</td>
</tr>
<tr>
<td>VI. DEVELOPMENTAL COSTS</td>
<td>84</td>
</tr>
<tr>
<td>The nature of developmental costs</td>
<td>84</td>
</tr>
<tr>
<td>The detailed accounting for developmental costs</td>
<td>87</td>
</tr>
<tr>
<td>The balance-sheet classification of developmental expenditures</td>
<td>94</td>
</tr>
<tr>
<td>VII. LOSSES</td>
<td>97</td>
</tr>
<tr>
<td>Operating losses during the developmental period</td>
<td>97</td>
</tr>
<tr>
<td>The nature of developmental operating losses</td>
<td>97</td>
</tr>
<tr>
<td>The accounting treatment of losses of this type</td>
<td>98</td>
</tr>
<tr>
<td>Losses resulting from asset replacements</td>
<td>104</td>
</tr>
<tr>
<td>Chapter</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>------</td>
</tr>
<tr>
<td>The nature of replacement losses</td>
<td>104</td>
</tr>
<tr>
<td>The accounting treatment of replacement losses</td>
<td>106</td>
</tr>
<tr>
<td>Extraordinary losses</td>
<td>109</td>
</tr>
<tr>
<td>The nature of extraordinary losses</td>
<td>109</td>
</tr>
<tr>
<td>The accounting treatment of extraordinary losses</td>
<td>110</td>
</tr>
<tr>
<td>VII. EXPENDITURES FOR EXTENSIVE REMODELING, REARRANGEMENT AND REINSTALLATION OF EXISTING FACILITIES</td>
<td>113</td>
</tr>
<tr>
<td>The nature of these expenditures</td>
<td>113</td>
</tr>
<tr>
<td>The accounting treatment of such expenditures</td>
<td>114</td>
</tr>
<tr>
<td>Immediate write-off or capitalization</td>
<td>115</td>
</tr>
<tr>
<td>Amortization basis</td>
<td>119</td>
</tr>
<tr>
<td>Recording the capitalization</td>
<td>121</td>
</tr>
<tr>
<td>IX. BOND DISCOUNT AND CALL PREMIUM</td>
<td>126</td>
</tr>
<tr>
<td>Unamortized discount on outstanding bonds</td>
<td>126</td>
</tr>
<tr>
<td>The nature of unamortized discount on outstanding bonds</td>
<td>126</td>
</tr>
<tr>
<td>The accounting treatment of discount on outstanding bonds</td>
<td>127</td>
</tr>
<tr>
<td>Unamortized discount and call premium on bonds which have been refunded</td>
<td>135</td>
</tr>
<tr>
<td>The nature of unamortized discount and call premium on refunded bonds</td>
<td>136</td>
</tr>
<tr>
<td>The accounting treatment of unamortized bond discount and call premium on refunded bonds</td>
<td>137</td>
</tr>
<tr>
<td>CHAPTER</td>
<td>PAGE</td>
</tr>
<tr>
<td>---------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>X. SUMMARY</td>
<td>143</td>
</tr>
<tr>
<td>Model Company balance-sheet</td>
<td>157</td>
</tr>
<tr>
<td>SELECTED BIBLIOGRAPHY</td>
<td>158</td>
</tr>
<tr>
<td>VITA</td>
<td>164</td>
</tr>
</tbody>
</table>
ABSTRACT

The deferred charges classification, as presently constituted, embraces a variety of items which are, to a large extent, unlike and unrelated to one another in nature and function. The usefulness of this section in current balance-sheets is questionable. Many individuals look upon the section with considerable doubt and suspicion; many analysts eliminate the section completely.

The purpose of this dissertation is to evaluate the traditional accounting treatment of deferred charges and to offer recommendations which will result in a more useful presentation of the items currently identified as deferred charges. The analysis undertaken is based upon a study of basic accounting concepts. The items investigated are those which examination of recent balance-sheets and current accounting literature reveals to be the most common deferred charge items.

The detailed procedure customarily followed in accounting for prepaid expenses is satisfactory. However, the presentation of these short-term prepayments in the deferred charges section of the balance-sheet results in an inaccurate presentation of working capital assets. It is therefore recommended in this study that prepaid expenses be classified in the current asset section with other working capital assets.

The customary accounting treatment of organization
and developmental expenditures results in an immediate (or arbitrarily rapid) write-off of such costs. This treatment reflects a liquidation attitude, in conflict with the going concern concept. It is recommended that such expenditures be capitalized and classified as intangible assets, to be amortized as expense equitably over the periods benefiting therefrom.

Normal losses arising during the developmental period have traditionally been written off immediately (or as rapidly as earnings will permit). Inasmuch as such losses are necessarily incurred in the establishment of the going concern, they should be recognized as valid developmental costs and should be accorded the treatment recommended for such costs. Replacement losses and extraordinary losses, often treated as deferred charges, should be written off immediately. Such losses do not represent costs which benefit future periods.

Expenditures for remodeling, rearranging, and reinstalling existing facilities represent costs relating to specific tangible facilities. The traditional classification of such costs as deferred charges does not produce an accurate statement of the costs of tangible facilities presently in use. It is recommended that such costs be identified directly with the facilities to which they relate rather than as deferred charges.

Unamortized discount relating to outstanding bonds, traditionally presented as a deferred charge, in reality
represents unaccrued interest on the net amount initially borrowed. It is recommended that this item be reflected in the presentation of the liability for the amount borrowed to date rather than as a deferred charge. With regard to unamortized discount and call premium on refunded bonds, it is recommended that these items be written off immediately. They relate exclusively to past periods; future periods derive no benefit from them.

The cumulative effect of the recommendations in this dissertation is, thus, complete elimination of the customary deferred charges section of the balance-sheet. Items currently presented in that section may be more meaningfully and more usefully presented elsewhere in accounting statements.
CHAPTER I

INTRODUCTION

THE NATURE OF ACCOUNTING

"Accounting consists of the concepts, principles, standards, rules, and technical procedures by means of which the economic or financial data of the business enterprise are gathered, classified, recorded, and periodically analyzed and reported for the benefit of interested parties."1

A comprehensive definition of a subject as broad as accounting is not possible in a single, brief statement. The best that any such statement can do is to emphasize certain aspects of the subject. The above definition has been selected for use in this discussion because it highlights two characteristics of accounting which influence the method of attack employed in the analysis of the problem of accounting which is investigated in this study. A brief description of these two characteristics is desirable before stating the problem which is the subject of this study.

The Purpose of Accounting

The basic function of accounting is to furnish financial information concerning a business enterprise to individuals and groups who have interests in that enterprise.

Many years ago when the typical business enterprise was

a small, local establishment, financed, managed, and largely operated by a sole proprietor, the proprietor was the only one who had an interest in financial data of the enterprise. Under those conditions, he was the only one to be served by the accounting process.

With the passing of time, changes have taken place. The typical business enterprise of today is quite different from that described above. The corporate form of organization has had considerable influence in the changes. The typical enterprise of today is much larger than its counterpart of a century ago. With the growth in size have come a greater separation of ownership and management and an increased use of creditor-capital as compared with proprietary-capital. With the growth in size has also come an increased responsibility of the enterprise to society. It is this, in addition to taxation of the enterprise, which has brought about an increased interest of the government in the business enterprise. Because of these changes, instead of just a sole proprietor there are now several groups who may be interested in the financial data of a business enterprise: management, present and potential investors (including owners and creditors), employees, and government.

In spite of these changes in the business enterprise, the general purpose of accounting remains the same—to furnish useful financial information to those who have interests in the business enterprise. However, with a variety of interested groups to be served rather than a single one, the fulfillment of that purpose has become more difficult.
With the changes and growth in the business enterprise, it has been necessary for the accounting process to change and expand in order to meet the challenge.

The Structure of Accounting

Accounting is made up of a multitude of conventions, doctrines, principles, rules, procedures, methods, techniques, and practices. The elements in the structure of accounting range from those which are of rather superficial nature to those which are properly considered of fundamental and basic significance. At one extreme are the practices and techniques which relate wholly to the mechanical aspects of recording the financial data with which the accounting process deals. At the other extreme are to be found concepts which are of such fundamental significance that their influence may be traced throughout the structure of accounting. It is with this group that much of the discussion to follow will deal and for convenience in this discussion the term "basic accounting concepts" will be used to refer to it.

In analyzing the structure of accounting these basic accounting concepts may be compared with the girders in the framework of a building. They give to the structure of accounting its stability and basic shape. With this framework as a start, the "edifice" of accounting is then fashioned by the addition of specific procedures, practices, methods, and techniques of a lower order. The general shape of the structure is thus determined by an underlying
framework of basic concepts; the more minute features of it are determined by specific procedures, practices, and so forth. The effectiveness of the overall structure in fulfilling the purpose of accounting depends to a large degree on the extent to which the specific procedures and practices are fashioned to conform to the underlying framework and to harmonize with one another.

The recognition of the relationship that exists between the basic concepts of accounting and specific accounting procedures and practices suggests the logical use of these basic concepts as criteria in judging and evaluating specific procedures and practices in accounting.

STATEMENT OF PURPOSE

In accounting practice today the term "deferred charges" is customarily used to refer to several types of items which are rather dissimilar in nature. The term is also used as the caption for the section in which these heterogeneous items are presented on the balance-sheet.

A cursory examination of the procedures traditionally followed in accounting for these deferred charge items will reveal practices which are quite different from, and inconsistent with, the accounting practices which are followed in other areas of accounting. Immediately the question arises: Is the traditional accounting treatment of deferred charges correct?

Current and past literature of accounting does not provide an adequate answer to this question. In most instances,
writers on the subject do little more than describe the procedures traditionally followed in accounting for deferred charge items. Little or no attempt is made to justify the customary procedures or to point out their weaknesses and to suggest other procedures to take their place.

It is the purpose of this dissertation to analyze and to evaluate the traditional accounting treatment of the items which are customarily identified as deferred charges. In this evaluation, the criteria to be used are the basic accounting concepts. Thus, the analysis is undertaken primarily from the standpoint of answering the question: How closely do the practices traditionally followed in accounting for deferred charges conform to the recognized and generally accepted basic accounting concepts? In those instances where nonconformance is noted, an attempt is made to discover the justification, if any, for such nonconformance. Where justification is found to be lacking, procedures and methods which are in conformance with the basic concepts are suggested.

The scope of this dissertation is limited in two respects. First, the individual items investigated in this study are those which are commonly identified as deferred charges in current accounting literature and practice. They are deemed to be the major deferred charge items. A variety of other items are occasionally classified as deferred charges, largely as a result of the tendency among some accountants to treat the deferred charges classification as a "catch-all" section. In this study, however, no attempt
has been made to investigate and to evaluate the accounting treatment of these occasional or incidental items.

The second limitation in scope is necessary because of the wide variety existing among those items which are investigated. The study of these items impinges on several diverse areas of accounting: the accounting for working capital assets, the accounting for tangible fixed assets, the accounting for intangible assets, and the accounting for losses. An investigation of the innumerable special problems, with all their complications and ramifications, which may arise in each of these areas, is deemed to be beyond the scope of this study. However, the investigation in this study is intended to be sufficient to provide a basis for the recommendation of general rules and principles for the correction of those weaknesses in the accounting treatment of the items investigated which stem from the traditional identification of these items as deferred charges.

ORGANIZATION OF THIS STUDY

The basic concepts which will be used as criteria in this study will be stated and described briefly in Chapter II. In connection with the description of these concepts, a number of terms which will be used in later chapters will be introduced and defined in the sense in which they will be used later.

The purpose of Chapter III is to describe briefly the general nature of the deferred charges classification in
accounting. The customary balance-sheet presentation of this section will be discussed, illustrated by citations from recent published balance-sheets.

Inasmuch as the various types of items customarily classified as deferred charges differ in nature from one another in many respects, each type will be given individual attention in this study. A separate chapter will be devoted to each of the principal types of deferred charge items (Chapters IV through IX). The organization of each of these chapters is substantially as follows: description of the traditional accounting treatment of the item, indication of weaknesses in the traditional accounting treatment, and recommendations for improvement in the accounting treatment.

In Chapter X the conclusions and recommendations in the preceding chapters dealing with specific deferred charge items will be summarized. In addition, several conclusions with regard to the general subject of deferred charges will be stated.
CHAPTER II

BASIC ACCOUNTING CONCEPTS

GENERAL NATURE OF BASIC ACCOUNTING CONCEPTS

In the literature of accounting today there is not universal agreement as to terminology for referring to what are here called basic accounting concepts. These same concepts are variously referred to as fundamental accounting principles, basic accounting postulates, accounting conventions, accounting doctrines, accounting standards, basic accounting assumptions, and accounting axioms. Individual authors are sometimes not consistent, using some of the above terms interchangeably. In spite of such disagreement in terminology, there is general agreement as to the existence of a body of concepts, axioms, or principles of such high order as to set them apart from the more mechanical and routine rules and practices of accounting. These concepts are not the direct result of action by legislative or parliamentary bodies although they have been influenced by actions of such bodies. They are not to be found formally stated initially in any constitution or code of regulations although reference to them is becoming more and more common in such documents. They are not the result of deliberate scientific research and experimentation, as are many of the scientific laws, although they have been influenced by many social and natural scientific phenomena. Instead, these
concepts are the result of gradual perception that the accounting process can be most useful if its detailed procedures and practices are devised and arranged in conformity with certain underlying assumptions, conventions, and doctrines.

It must not be assumed that these concepts are wholly immutable. Economic changes cause changes in the groups served by the accounting process. Corresponding changes and modifications may be expected in the basic concepts, followed by appropriate changes in practices and procedures. Such changes are necessary if accounting is to serve its purposes. Samuel J. Broad has warned against rigidity in the accounting process in the following words:

"The whole world is in a state of flux. For financial reports to be of service in these changing conditions accounting must be dynamic and virile, not static and placid. It can no more be static than the economy it serves. We cannot afford to be contented, to bind ourselves to the past, or to have progress restricted by the belief that whatever is right. Fluid mobility, rather than a Maginot line, is the need of the day."  

The realization of this characteristic of the basic concepts is of special importance in any study which attempts to use them as criteria for analysis and evaluation of specific procedures. The existence of inconsistencies and contradictions in detailed procedures and practices is sometimes the result of changes which are in the process of being made, the impact of which have not been felt simultaneously.

---

at all levels of the accounting structure.

A second feature of these basic concepts must also be appreciated if they are to be used as criteria as indicated above. These concepts are not of such dominating nature and universal applicability that no variation from them is possible.² It may be well to recall the familiar expression, "The exception proves the rule." No doubt this saying has often been used in attempts to defend rules of dubious validity simply by naming exceptions. Nevertheless, the adage does have value in that it implies that a single variation or possibly several variations do not alone nullify the validity of a rule of wide applicability. Extenuating circumstances may serve to justify certain variations from general rules in accounting as well as in other areas of human activity.

A third feature of the basic concepts must also be considered. At times there may be conflict between basic concepts themselves. This sort of conflict has been likened to the conflict sometimes encountered between principles of law.³ The existence of such conflict in accounting concepts may, in some instances, be either the result of weaknesses in the concepts themselves or the result of improper interpretation.

²"An accounting principle is not a principle in the sense that it admits of no variation, nor in the sense that it cannot conflict with other principles. The analogy to principles of law suggests itself; they frequently conflict with each other, and in many cases the question is which of several partially, relevant principles has determining applicability. This situation is so familiar in law that it is surprising to find it giving rise to any question in accounting."

³Ibid., p. 60.
and application of the concepts involved. In any case, the exercise of judgment and discretion is often necessary in the application of the basic concepts to specific situations.

These three characteristics of accounting concepts should be kept in mind throughout the reading of the following description of the individual concepts which will be used in the later analysis and evaluation of the traditional accounting treatment of deferred charge items.

**UTILITARIAN VIEWPOINT OF ACCOUNTING**

One of the most significant and most pervasive of the basic accounting concepts is that which maintains that the viewpoint of accounting should be practical and utilitarian. Samuel J. Broad emphasizes the need for this viewpoint in the following words: "The primary test by which all economic values, whether goods or services, are judged is their utility or usefulness. Accounting must measure up to this test if it is to perform its function and continue to meet the needs of business and government and, in fact, the whole economy."\(^4\) All phases of the accounting process (as well as the process as a whole) should stand the test of utility, and the influence of the concept of usefulness should be observable throughout the gamut of other accounting concepts, principles, practices and procedures.

**IMMATERIALITY**

Professors Holmes and Meier have stated the concept of immateriality in the following words: "Items that are

\(^4\)Broad, *op. cit.*, p. 408.
immaterial in amount may be handled without regard to other theoretical considerations."

The concept of immateriality emphasizes the need for a practical approach in dealing with items which are inconsequential in amount. Several types of items of this sort may be encountered. A common example is the expenditure which is very small in amount but which is of such nature that several future accounting periods will receive benefit from it. A strict, idealistic treatment of such an expenditure would result in capitalizing the amount as an asset at the time of the expenditure and then periodically amortizing the amount as expense relating to the periods benefiting from the expenditure. It is obvious that a more simple (and cheaper) procedure would be to record the expenditure as expense in the period in which it takes place. If the amount of the expenditure is small (in relation to the size of the business) the simpler procedure would not result in any significant distortion or misstatement of the data and the concept of immateriality may be invoked as grounds for the use of the more expedient procedure.

The concept of immateriality clearly requires the recognition of relative significance of items. An amount which would clearly be deemed immaterial in size for a very large

---

6"The rule of materiality emphasizes the practical aspect that accounting theory is primarily a guide in the preparation of useful financial statements." Ibid., p. 275.
enterprise may be of very material significance in the case of a smaller firm. Repetitious transactions that are immaterial in amount individually may be material when taken in the aggregate and must be handled accordingly. Stephen Gilman has suggested the following rule for judging immateriality: "If an accounting decision is not sufficiently important to influence the comparability of financial statements, there may be some hint of immateriality." This rule may serve as a reminder that the concept of immateriality can be applied in connection with problems of statement presentation as well as with problems of recording routine transactions. Frequently in preparing financial statements it is possible to combine several items of inconsequential amount and which have little significance within themselves without such combination distorting the impression given by the statement. The usefulness of the statement may even be increased as a result of such treatment inasmuch as the significant data is less likely to be hidden in a maze of trivial items.

MEANINGFUL STATEMENT PRESENTATION

General Nature of the Concept

Financial statements and reports constitute the culmination of the accounting process. They are the means by which information is transmitted to the various groups interested in the business enterprise. Therefore, the degree of

success with which the accounting process fulfills its purpose depends to a large extent on the effectiveness of the financial statements in transmitting useful information to those groups.

It is not the purpose of this discussion to attempt a detailed statement of what constitutes proper statement presentation. Accountants in general have not reached complete agreement on many points of terminology, classification, and arrangement. An example of the disagreement which exists can be cited in the case of the opposite positions taken by two national accounting organizations on the desirability of the "all-inclusive" income statement. In recent years efforts to improve accounting terminology have almost reached the proportions of a crusade, although many accountants have been slow to adopt some of the recommended terms, and other accountants find little to be gained in some of the recent suggestions.

---

*The attitude of the American Institute of Accountants is indicated in the following quotation from the opinion of the Committee on Accounting Procedure: "... it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period."

The attitude of the American Accounting Association is that no exceptions should be allowed; all items of expense, loss, and revenue (even though relating to some prior period) should be included on the income statement. This position is expressed in the 1948 Revision of Accounting Concepts and Standards Underlying Corporate Financial Statements, published in leaflet form by the Executive Committee.*
The agitation for simplified statements, for informal statements for the layman, and for various special purpose statements has probably been greater in the past decade than in any other similar period in the history of accounting. In view of the variety of groups who now attempt to use accounting statements, there probably is justification for a greater variety of accounting statements than are customarily prepared today.

In spite of the conflict and dissension that exists in this area of accounting, there is general agreement on one basic concept of statement presentation: Accounting statements should present useful data in a form which will facilitate its use by interested parties; there should be full disclosure of all significant data, arranged in such a way as to facilitate its use and analysis.

Classification

Because of its impact on the later discussion in this study, special attention must be given to the "classification" phase of the problem of meaningful statement presentation.

Classification has been defined by Stockton as "a process of separating a mass of individual facts or observations into groups on the basis of some similarity." The effectiveness of any scheme of classification depends directly on the basis used for classifying the data. If a logical and

---

reasonable basis is used, significant facts about the mass of
data may be seen more easily than if the mass of data is left
unclassified. Meaningful ratios and percentages can be com-
puted more easily if the information is arranged in logical
groups. If an illogical basis is used in the classification,
the classified data may be confusing, and even misleading.

There are several bases which might be used for the
classification of assets. From a legal standpoint, assets
might be classified as tangible and intangible. From a
liquidity standpoint, assets might be classified as liquid and
non-liquid. In recent years, the functional basis of classifi-
cation has become widely accepted by accountants. Such a
classification of assets on the basis of their use in the
enterprise facilitates the use of the balance-sheet. Groups
of items which are logically related are more easily compared,
and the computation of many of the ratios and percentages
used by analysts today is facilitated.

On a functional basis the assets of an enterprise may
first be divided into two broad groups: those which are for
use in the regular business operations (operating assets),
and those not held for use in the major activity of the con-
cern. The latter may be called Investments. The former
group of operating assets may be divided into two parts: the
current or working capital assets (discussed more fully in
Chapter IV), and the noncurrent operating assets. In the
latter group would be classified the assets arising from ex-
penditures which are expected to render service and be of
economic significance to the enterprise over a relatively
long term. Tangibles such as land, buildings, and equipment, and intangibles such as patents, copyrights, and goodwill would be placed in the latter group (as long as they are held for use in the regular business operations). It is common practice in accounting today to divide the noncurrent operating assets into two groups: tangible noncurrent operating assets (often called Plant), and intangible noncurrent operating assets (called Intangible Assets). This subdivision aids those analysts who prefer to eliminate intangibles in their analysis.10

The functional classification of assets which will be used in this study may be summarized in outline form as follows:

I. Assets
   A. Assets not held for use in major activity of the concern: Investments.
   B. Assets held for use in major activity of the concern: Operating Assets.
      1. Current or working capital assets.
      2. Noncurrent operating assets.
         a. Tangibles: Plant
         b. Intangibles: Intangible Assets

These classification sections correspond closely with those

10Intangible assets . . . are commonly eliminated from the assets and capital for analytical purposes," Ralph Dale Kennedy and Stewart Y. McMullen, Financial Statements (Revised Edition; Homewood, Illinois: 1952), p. 146. In similar vein, Myer states that "it has become standard practice to disregard them (intangibles) entirely in the analysis of financial statements in order to avoid the possibility of an erroneous valuation of the assets. The analyst merely deducts their amount from the assets and from the net worth." John N. Myer, Financial Statement Analysis (New York: Prentice-Hall, Inc., 1939), p. 46.
advocated by many leading accountants today except that no provision is made in the above outline for a deferred charges section. (The justification for this omission is discussed in the following chapters of this study.)

OBJECTIVITY

The backgrounds, attitudes, and interests of the various groups that use accounting statements differ from one another and in some respects tend to conflict with one another. If accounting statements are to be most useful in fulfilling the needs of these groups they should be objective statements of facts to the greatest extent practicable. The influence of personal opinion, wishful thinking, individual prejudice, caprice, and other such subjective elements may unavoidably enter into the interpretation of the information by the various groups using it but should not be reflected in the information when it is presented to them. All such groups will be served with equity if they are presented with information of a factual nature insofar as possible and are then permitted to make their own interpretations and form their

---

own opinions.

In the course of the business activities, several degrees of objectivity may be found. As suggested by Professors Paton and Littleton, the evidence may be completely objective, convincingly objective, doubtfully objective, or clearly un-objective.\textsuperscript{12} For accounting purposes, that which is completely objective is most desirable. However, in observing this concept of objectivity, care must be taken not to abandon another equally important concept in the structure of accounting, the going concern concept which will be discussed later in this chapter. In the attempt to be completely objective at all times there is a danger of adopting a short-run point of view which, although objective in a sense, would be very unrealistic. For example, such a point of view would dictate that no part of the cost of an item such as a machine need be considered as expense in the early years of the life of the machine because there has been no observable decline in its efficiency or productivity. Most accountants today agree that objectivity, even though less than complete objectivity, coupled with the going concern concept is more to be desired than complete objectivity coupled with a short-run viewpoint.

It must be recognized that accounting records based on evidence which is less than completely objective may be shown to be incorrect when more objective evidence becomes available. In such cases, corrections can be made and reflected in

\textsuperscript{12} W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (American Accounting Association, 1940), pp. 19-20
subsequent statements prepared in the light of the more objective evidence.

The concept of objectivity makes itself felt in several areas of accounting. Its interrelationship with the going concern concept has already been noted. In the later discussion of cost as a valuation basis, its influence will be noted. The influence of the concept of objectivity will also be noted in the discussion of the concept of matching costs and revenues.

CONSISTENCY

In its application in accounting the concept of consistency has two aspects. The one which has received the greatest attention in discussion and writing thus far is that which refers to uniformity of procedures and practices as between periods. There are many areas of accounting in which different procedures and practices may be acceptable. For example, a variety of depreciation methods have received recognition as acceptable for the periodic amortization of the cost of certain assets. LIFO, FIFO and several other methods have received general acceptance for merchandise cost identification purposes. Each of the methods will give the same result when considered from the standpoint of the total life-span of the enterprise but the periodic cost assignment by each may be quite different.\textsuperscript{13} In any such areas where

\textsuperscript{13}"It has frequently been said, in accounting discussion, that the choice of one practice rather than another is in many cases less important than that the practice chosen shall be consistently followed from period to period." \textit{Contemporary Accounting} (New York: American Institute of Accountants, 1945), Chapter 1, p. 20.
alternative methods are available, the concept of consistency requires that one method be followed consistently in order to assure uniformity and comparability of periodic reports. This aspect of the concept of consistency is deemed to be of such importance that specific reference to it is made in the typical auditor's opinion and in many income tax and other governmental regulations relating to accounting procedures and practices.

A second characteristic of this concept requires consistency within the accounting records without regard to the time element. The treatment accorded a given item in one area of the accounting process should be consistent with the treatment accorded that item in other areas of the process. An example of this is found in the statement of depreciation on an asset for which the valuation basis has been changed from cost to an appreciated value in excess of cost. Although some accountants would prefer to recognize depreciation expense on the item still on the basis of cost, the Committee on Accounting Procedure of the American Institute of Accountants has declared that the statement of depreciation expense

---

14 The opinion paragraph of the short-form report suggested by the Committee on Auditing Procedure of the American Institute of Accountants is as follows: "In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19-- , and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year." Codification of Statements on Auditing Procedure (New York: American Institute of Accountants, 1951), p. 16.
on the income statement should be on a basis consistent with
the valuation base used for the asset on the balance sheet.
The Committee's reasoning was as follows: "A corporation
should not at the same time claim larger property values in
its statement of assets, and provide for the amortization of
only smaller sums in its statement of income."15

THE ACCOUNTING ENTITY

Professors Paton and Littleton have pointed out the in-
stitutional nature of accounting in the following manner:
"In accounting the business fabric is conceived in terms of
specific enterprises and these units are construed as focal
points of recording and reporting."16 The accounting process
is not designed to record, summarize, and report the financial
transactions of the economy as a whole. Instead it is to be
applied to the relatively small unit carrying on fairly closely
related activities within the economy. This unit has been
variously called the economic entity, the economic unit, the
business enterprise, the business entity, the accounting
tity, the enterprise, or simply the business. Regardless
of the name employed, this unit for accounting purposes is
deemed to be complete within itself and the accounts are kept
and statements prepared with the attitude that the entity is

15Accounting Research Bulletin Number 5 (April 1940),

16Paton and Littleton, op. cit., p. 21.
distinct and apart from its owner or owners.\textsuperscript{17}

The boundaries of the unit are determined, in part, by economic considerations and, in part, by legal considerations. The ideal case is that of a corporation engaged in a single economic endeavor. In such a case an organization exists which is legally separate and distinct from those who have furnished the capital, and the activities of the organization have a distinct economic coherence or homogeneity. An accounting for the assets committed to the enterprise and for the equities which rest therein clearly has legal and economic significance. In other cases where such ideal conditions do not exist, the entity concept nevertheless strongly influences the attitude of the accounting process. If the enterprise mentioned above were conducted as a sole proprietorship or partnership, it would still be considered as a distinct entity for accounting purposes even though the organization cannot, from the legal standpoint, be considered entirely apart from the owner or owners. Under such conditions, adherence to the entity concept results in only minor legal complications, at the most, and there is clear justification for letting economic considerations prevail.

\textsuperscript{17}"It is 'the business' whose financial history the book-keeper and the accountant are trying to record and analyze; the books and accounts are the records of 'the business'; the periodic statements of operation and financial condition are the reports of 'the business'; the assets are the properties of 'the business', and the equities are its ownership and obligations." William Andrew Paton, Accounting Theory (New York: The Ronald Press Company, 1922), p. 473.
There are some cases where strict adherence to the entity concept would result in legal complications of such magnitude that they outweigh economic considerations with the result that the entity concept is often modified in such cases. An example of such a case would be a corporation engaged in several rather unrelated (from the economic standpoint) activities. Under such conditions, legal considerations practically require that the accounting process provide information for the organization as a whole, although economic considerations would suggest the desirability of accounting for the activities individually. Departmentalization of the accounting records affords a partial solution to this problem. A second example of a case where adherence to the entity concept encounters conflict between legal and economic considerations is that of the parent-subsidiary organization. Frequently in such cases several corporations which are legally separate are carrying on a single economic endeavor. In such a case, legal considerations require separate accounting for the individual companies whereas economic considerations would suggest the usefulness of reports for the endeavor as a whole. The preparation of consolidated statements (in addition to statements for the corporations individually) is frequently resorted to in such cases.

In spite of the complications found in cases such as the two just cited, there is no doubt but that the accounting process is deliberately designed to account for the financial affairs of a single entity. This concept will be found to influence many of the procedures and practices of accounting
THE ACCOUNTING PERIOD

"All measures of income for periods less than the total lapse of time during a relationship or less than the duration of an enterprise are approximate indexes only."\(^{18}\) "Profits are accurately and definitely determinable only when a business ceases and is liquidated."\(^{19}\) These statements by Canning and Kester, respectively, emphasize the tentative nature of periodic profit determinations in accounting.

In spite of the warnings implied in the above statements, it is obvious that a single computation of profit or loss at the time of the termination of an enterprise would be far less useful for most businesses than periodic approximations. Today there are demands from all sides for frequent profit computations. Management requires them for administration and policy-making purposes. Investors, both creditor and proprietary, expect them. Governmental agencies, taxing and otherwise, demand them. As a result, one of the most firmly established concepts in modern accounting is that of periodic reporting. Indeed, Paton has suggested that accounting "might almost be defined as the art which attempts to break up the financial history of a business into specific

---


units, a year or less in length." 20

It is interesting to note how many of the problems of present-day accounting arise because of the attempt to measure income periodically. In the absence of the concept of periodic reporting there would be no need to distinguish between capital and revenue expenditures. Without the periodicity concept there would be no need to consider the related concepts dealing with the going concern, the problem of matching effort and accomplishment, and the assumed adhesive nature of costs. (These concepts will now be discussed.)

THE GOING CONCERN CONCEPT

As soon as it is recognized that there is need for fairly frequent interim financial test-readings a new problem arises. Upon what basis shall such reports be constructed? One approach might be termed the "periodic dissolution" approach in which it is assumed that the business entity is dissolved at the end of each accounting period, selling its assets to a new entity which also assumes the liabilities of the old entity. The new entity, in turn, will be liquidated at the end of a single period and replaced by still another entity, and so on ad infinitum.

A second approach, that which is customarily taken in accounting today, might be termed the going concern approach. Under this approach it is assumed that the business entity

has continuity of life and that the periodic accounting reports serve simply as test-readings on the continuous stream of economic activities of the enterprise. Properties used by the entity are deemed to have been irrevocably dedicated to the carrying on of the purposes of the entity and will remain in use as long as they serve those purposes. The liquidation or market values of such properties at the time of statement preparation is therefore of secondary importance for statement presentation purposes. The statements attempt to show the extent to which such assets have been consumed or exhausted by their use in the productive activities of the enterprise and the residue that remains for future consumption.

The going concern approach not only has significant impact on the valuation of assets in accounting, but it also influences the statement presentation of equities. In accordance with this concept, it is not imperative (in fact, not proper in certain cases) to state on a given balance-sheet each liability item at its immediate claim in liquidation or even at its maturity claim, if the maturity date of the liability is at a future date. In the later discussion of another basic concept, attention will be given to the amount at which such items should be stated. It is sufficient at this point to note that the going concern concept applies with equal force to the accounting for liabilities as to the accounting for assets, and that, in accordance with it, it is assumed that all claims will be carried by the business until their normal maturity dates.
Of the two approaches which have been discussed briefly above, it must be admitted that some degree of unreality exists in each and that lack of objective evidence is a problem in the application of either, though to a lesser degree in the case of the going concern approach. Since it is obvious that the two approaches are in conflict with each other, statements cannot logically be prepared on the basis of both. Accountants today have arrived at fairly universal agreement on the use of the going concern approach, although some seem reluctant to abandon the other completely. No doubt some of the inconsistencies in accounting practice today can be traced to this reluctance, and some of the objections leveled at present-day accounting statements by non-accountants are the result of the objectors viewing the statements from a liquidation standpoint rather than from the going concern standpoint which was taken by those who prepared them.

MEASURED CONSIDERATION

There are two features of the accounting process which have no unique influence on the traditional accounting for deferred charges but which should be mentioned briefly before entering into the discussion of the concept of measured consideration.

The accounting process is designed to provide information expressed in terms of money. Assets, liabilities, expenses, revenues, and so forth, all are expressed in terms of dollars and cents. This mode of expression is not inherent in the
accounting process. In the case of the simple venture such as may have been conducted by the Roman slave for his master, the records could easily be expressed in units other than money such as the bushel, the barrel, the pound. However, for complex business enterprises of today there is universal acceptance of money as the medium for expressing basic accounting data.22

Unfortunately this medium of expression does not possess a unit of fixed and unvarying size. Accountants no doubt would be among the first to admit this; but thus far no suitable substitute has been devised. Several proposals have been advanced for compensating for monetary fluctuations,23 but none has thus far received much more than academic attention. As a result, accounting statements admittedly often combine "deflated" dollars with "inflated" dollars just as though they were strictly homogeneous. The finding of a remedy for this condition seems still to be in the future and is not the purpose of this study. Accountants now express their information in terms of money and prepare their statements just as though the unit of expression was constant in value.


22This is not to be interpreted as meaning that additional data expressed in other ways is not to be found at all. Supplementary information relating to quantity of production, quantity sold, number of employees, number of stockholders, etc., frequently accompanies the basic accounting data and enhances the usefulness of the reports.

23Perhaps the most outstanding contribution in this field to-date is that of Henry Whitcomb Sweeney, Stabilized Accounting (New York: Harper and Brothers Publishers, 1936)
Even after the medium of expression has been recognized, a question still remains. How shall the amounts to be recorded be determined initially? As an aid in expressing an answer to this question, Professors Paton and Littleton suggest the use of the term measured consideration as a substitute for what are sometimes stated as transaction cost and transaction price.

"The activities of the specific business enterprise, with respect to which the accountant must supply pertinent information, consist largely of exchange transactions with other enterprises. Accounting undertakes to express these exchanges quantitatively. The basic subject matter of accounting is therefore the measured consideration involved in exchange activities, especially those which are related to services acquired (cost, expense) and services rendered (revenue, income)."

One of the applications of this concept is in transactions involving the acquisition of properties or services. When such acquisitions take place the amount at which each is to be recorded is the measured consideration agreed upon by both buyer and seller in the transaction. This is commonly referred to as the cost to the buyer. This amount is deemed to be objectively determined inasmuch as it is, in most cases, the result of bargaining between two parties with opposing interests. The amount also measures the value of the service benefits acquired by the enterprise in the transaction so that at this point, value in the usual economic sense, and cost in the accounting sense, are one and the same. Initial cost may now be defined as the measured consideration involved in the

---

24 Paton and Littleton, op. cit., pp. 11-12.
acquisition of properties or services by the enterprise and represents the value of those properties or services at the time they were first dedicated to the purposes of the enterprise. If this concept is considered in conjunction with the going concern concept it will be recognized that for accounting purposes the significant amount at the date of acquisition (with respect to expenditures for properties and services) is cost and the significant amount at any subsequent date is the unconsumed portion of that cost rather than any realization value or market value at any such later date.

A second application of the concept of measured consideration is in the measurement of revenue received by the enterprise for services rendered. In such a revenue transaction the amount to be recorded in the accounting records and which represents value received, determined objectively by independent bargaining, is the transaction price or measured consideration involved in the transaction.

A third application of this concept relates to loan contracts. The amount to be recorded at the time a loan contract is entered into is determined by the measured consideration passing between creditor and debtor at the time of the transaction even though that amount may be more or less than the maturity amount of the contract. Any difference would be due to the interest factor and should be amortized systematically in such a way as to bring the amount initially recorded as liability into agreement with the maturity amount by the time the maturity date has arrived. It is this feature of the concept that is sometimes overlooked, resulting in a
liquidation approach in accounting for liabilities even though assets may at the same time be accounted for in conformance with the going concern and measured consideration (or cost) concepts.

ACCOUNTING COSTS ARE DIVISIBLE, MOBILE, AND ADHESIVE

In the discussion of the concept of measured consideration it was pointed out that ordinarily when an enterprise acquires properties or services, the amount to be entered in the accounting records relative to such items is their cost as indicated by the measured consideration involved in the acquisition transaction. The subsequent accounting treatment of such costs is influenced to a large extent by a closely related basic accounting concept. The latter concept provides that a cost element entered in the accounting records can be treated as though it is divisible into minute particles (even though it relates to a property which is physically indivisible), that such particles of cost are mobile and can therefore be moved about within the accounting records, and that several such particles can be combined or assembled to form a new cost aggregate. In accordance with this concept, the accounting for costs in a manufacturing enterprise can be arranged in assembly line fashion closely paralleling the assembly line used in the physical production of the product manufactured. In such an arrangement, particles of cost relating to materials used in manufacturing are combined with cost particles relating to labor employed in the process. To these are then added cost particles relating to other properties
and services which, though perhaps not as directly identifi-
able with the productive process as direct material and direct
labor, have nevertheless been acquired to further the produc-
tive process and are exhausted or consumed either immediately
or bit by bit as it is carried on. The product of this
accounting cost-assembly process is an aggregate of cost
particles which is considered to be the cost of the product
produced. This concept of "regroupable" costs is most in-
triguing when applied as above in the case of a manufacturing
enterprise. The concept is none the less applicable in the
case of a trading or service enterprise.

MATCHING COSTS AND REVENUES

The broad purpose which lies behind the myriad activities
of the typical business enterprise is the attainment of accom-
plishments which exceed the efforts expended thereon, resulting
in net benefit to the enterprise. The extent to which such
accomplishments exceed (or fall short) of the efforts expended
is a matter of paramount importance to those who are interested
in evaluating the effectiveness of the enterprise. It is
through the computation of income, as expressed in statement
form on the income statement, that the accounting process
attempts to provide useful information on this subject.

The net result of the activities of a business can be
determined with exactitude only at the time of its liquidation
by comparing the total of efforts expended with the total of
accomplishments resulting. Nevertheless, the demand for
interim test-readings (even though necessarily provisional)
has been so great that periodicity has become a basic element in the accounting process, and it is in the preparation of such periodic statements that a serious problem of relating costs and revenues is encountered. In the case of the going concern there is a more or less continuous stream of efforts and a more or less continuous stream of accomplishments. These two streams, however, do not necessarily flow at the same rate. The flow of efforts for a given period of time may not be strictly comparable with the flow of accomplishments measured over the same period. In many instances efforts are dedicated to the purposes of the enterprise in one period and the accomplishments which stem from those efforts manifest themselves in a subsequent period. Because of such instances, care in computing net benefit for a period must be observed to insure that the matching of efforts with accomplishments is proper.

In the accounting process, costs are considered to measure efforts; revenues are considered to measure accomplishments. For this reason the problem will henceforth be referred to as one involving the proper matching of costs and revenues. The excess of revenues over related costs will be referred to as income and an excess of costs over related

---

25Revenue may be defined as the "flow of funds from the customers or patrons in exchange for the product of the business, either commodities or services." Paton and Littleton, op. cit., p. 47. The amount recorded for such new assets is the measured consideration involved in the transfer transaction between the enterprise and its customers. This is in conformity with the concept of measured consideration.
revenue will be referred to as a loss.

In preparing a computation of income for a given period the aggregate of revenues to be reported for the period must first be determined. This raises the question of just when are revenues to be recognized for income computation purposes. To undertake an adequate answer to the question is beyond the scope of this study. It is sufficient to note that it is convenient to recognize revenue in the period in which it is realized and, as a general rule, subject to several reasonable exceptions, revenue is deemed to be realized when the products or services of the enterprise are converted into cash or other valid assets. The sale is the point where this conversion usually takes place.

Once the aggregate of revenues to be recognized has been determined there remains only the matter of arraying against those revenues the costs which have been consumed in bringing about the realization of the revenues. In many instances this is more easily said than done. Many costs can be directly identified with units of product or service of the enterprise. Because of the divisible, mobile, adhesive characteristics of costs, directly identifiable costs can be accumulated in the accounting records in terms of units of product or service. When the unit then reaches the point at which revenue is to be

26"... there must be a determination of the revenues properly allocable to a period, and that having done so, there must be a corresponding allocation to the same period of all costs which properly attach to the earnings of the revenues with which the period has been credited." Contemporary Accounting (New York: American Institute of Accountants, 1945), Chapter 1, p. 15.
recognized as realized, these accumulated costs are obviously to be matched against that revenue. As pointed out by Paton and Littleton, "Not all costs attach in a discernible manner, and this fact forces the accountant to fall back upon a time-period as the unit for associating certain expenses with revenues. Time periods are a convenience, a substitute, but the fundamental concept is unchanged." The fact that certain costs are not directly identifiable with any tangible property should not be construed as conclusive evidence that they should immediately be charged against current revenues. In dealing with such costs, ingenuity and judgment should be employed in the light of all attendant circumstances. It is in this area that the doctrine of conservatism (to be discussed later in this study) is sometimes allowed to play a misleading role.

The above discussion perhaps has tended to imply that as cost elements are exhausted, revenue is an inevitable outcome. Of course this is not true. Exhaustion may take place with no revenue resulting. A new building which has just been dedicated by the enterprise to the production activities of the business may be destroyed by fire, flood, or other calamity. The revenue potential of the building will never be realized. Unexpected changes in style or taste may result in abandoning a machine which is still far from physically exhausted. In any such cases the costs relating to property which have not been previously matched against revenues arising from the property may be considered as measuring the

\[\text{\textsuperscript{27}}\text{Paton and Littleton, op. cit., p. 15.}\]
efforts dedicated by the enterprise but which will not be effective in bringing forth any future accomplishments. To attempt to match such costs against revenues produced by other properties in future periods would clearly be improper. To attempt to match them retroactively against past revenues arising from the property involved is normally not feasible. The only recourse is to assign them to the computation of income of the period in which exhaustion was recognized to take place. In so doing, such an item should be clearly identified for statement purposes as being an extraordinary assignment not regularly assignable against the revenues of the period.

Before proceeding it may be well to note several terms, closely related to the above concept, and the sense in which such will be used hereafter.

Cost is the accounting measure of the effort dedicated by the enterprise in the acquisition of goods or services. The amount is determined by the measured consideration involved in the acquisition transaction.

Expense is the portion of cost which is matched against related revenue in the computation of income for a given period. The term will here be used to include not only those items commonly referred to as expenses on income statements but also the item often described as cost of goods sold. Both such cost expirations stand on the same footing with respect to the production of revenue, neither having priority, so that it is reasonable to include the two in the same class for terminology purposes.
Loss is a cost expiration which has been ineffective in producing revenue. The term is also used to describe the extent to which an aggregate of cost expirations exceeds the revenues against which they are being matched.

Book value is the portion of a cost element which has not yet been assigned as expense as of a given time. "Un-expired cost" is perhaps more descriptive, but book value is firmly entrenched in the terminology of accounting today.

Asset has been defined by one of the foremost accounting authorities as "any factor, tangible or otherwise, owned by a specific business enterprise and having economic significance to that enterprise."28

Income is the excess of revenues recognized for a given period over the expenses assignable thereto.

CONSERVATISM

In discussing conservatism in accounting, Gilman states that it "is one of those vague but sanctified concepts like honesty, morality, democracy, and Nordic supremacy, so much so that its critics generally consider it necessary to tread lightly as if on holy ground."29

There was a time when accounting statements prepared by public accountants were used almost exclusively for the purpose of supporting requests for short-term credit. Credit grantors gave practically all of their attention to the balance-sheet

with little or no attention to the statement of earnings. The possibility of asset overstatement was a matter of grave concern to them. Their influence made itself felt in the attitude of accountants. With the overstatement of assets being considered such a serious vice, it was natural for the understatement of assets to attain somewhat the status of a virtue. Under these influences, items which would otherwise undoubtedly have been admitted to the balance-sheet as assets were excluded in order to be conservative. In addition, the practice of anticipating losses but not anticipating profits, and the practice of valuing merchandise on a lower of cost or market basis became popular. It is not the purpose of this discussion to attempt to weigh the merits of such practices. Perhaps under the conditions that existed in those days they were justified.

With the passing of the years, conditions have changed. Today, credit grantors are taking as much interest in the earning power of the enterprise as in its asset position. Their emphasis has shifted from the balance-sheet to the income statement. Today the statements are not prepared for the use of credit grantors alone. As has been noted already, there are several groups who make use of the information furnished on the statements. In the light of these conditions, several weaknesses in the traditional practice of conservatism are apparent. An unwarranted write-off of an asset in order to be conservative no doubt does avoid the possibility of overstating assets on the current balance-sheet, but such action simultaneously unwarrantedly overstates expenses for the current
period and thereby understates income for the current period. By so doing, those who now devote much attention to the income statement are led to believe that earnings are now less than they really are. Credit grantors may then refuse to make loans which they would like to make if they knew the true condition of the business; stockholders are depressed over the low income of their corporation and as a result may sell their stock for less than its real value; others, including even governmental tax-gathering agencies are likewise misled. But, the distortion does not end there. The immediate recognition as expense of costs which should instead be spread as expense over several future periods results in understating the expenses recognized in those future periods, thereby overstating the income reported in those future periods. Such repercussions can hardly be described as conservative.

The practice of conservatism in the traditional sense is clearly in conflict with several of the basic concepts presented in the preceding pages. The immediate write-off of costs which will in reality aid in producing revenues in future periods results in an imperfect matching of costs and revenues. The omission of such valid assets from the balance-sheet results in something less than full disclosure of material information. The anticipation of losses but not of profits, and the cost or market valuation practice certainly contribute little toward increasing consistency in the accounting process.

In recent years there has been rather widespread abandon-
ment of some of the practices heretofore sanctioned by
Conservatism. Deliberate misstatements are not condoned; arbitrary asset write-offs are frowned upon. Conservatism, as interpreted in accounting today means little more than when in doubt, be pessimistic.
CHAPTER III

THE NATURE OF THE
DEFERRED CHARGES CLASSIFICATION

DEFERRED CHARGES IN THE BROAD SENSE

"From an accounting viewpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose or expectation that they shall be the means of producing profits in the future."¹ One of the main functions of the accounting process, therefore, is that of holding the amounts of such expenditures or charges "in suspense" until the time when they should be matched as expenses against the revenues to which they relate. While being held in suspense these amounts constitute assets. As Professor Littleton has said: "The only difference between asset and expense is one of time of appropriation or association with specific units of income."²

If the term is used in a broad sense most of the assets of an enterprise may be referred to as deferred charges. Expenditures for merchandise, machinery, furniture, fixtures, buildings, patents, copyrights—all may be described as charges which, for the time being, are being held in suspense


²Littleton, op. cit., p. 201.
(as assets) until the time comes for assignment against revenues as expenses. Professor Mason has referred to the closeness in the meanings of the terms assets and deferred charges (in the broad sense) in the following way: "If we can think of the investment in an asset, then, as the price paid for a series of future services, the asset account may well be thought of as a deferred charge to operations or a prepaid operating expense."³

Stephen Gilman has the distinction of suggesting the possible use of the term deferred charges with a still broader meaning than that indicated above. Although he does not recommend it in preference to the more orthodox classification of assets for balance-sheet purposes, Gilman suggests the possibility of classifying assets in three groups: deferred charges to future income, deferred charges to cash, and cash.⁴ The first group would consist almost entirely of assets such as those named in the paragraph above—those assets which should be assigned as expense periodically in the determination of the amount of periodic income. The second group includes those assets which are held primarily for the purpose of being converted into cash rather than for the production of revenue in the future. Notes and accounts receivable are the most obvious examples of this group. The composition of the third group is self-evident.


⁴Gilman, op. cit., p. 300.
although some questions of classification might arise in the
case of cash in the custody of a cashier or on deposit in a
bank.

For the purposes of the present study, the term deferred
charges will not be used in either of the senses mentioned
above. The customary usage of the term in accounting is much
narrower and more technical, as is noted below, and it is in
that sense that the term is used in this study.

DEFERRED CHARGES IN THE LIMITED SENSE

In accounting today the term deferred charges is used to
refer to a fairly small group of items, and it is used as the
caption or title for the section of the balance-sheet in
which these items customarily are classified. Deferred
charges is probably the most commonly used term for this
section but other terms are sometimes used.\footnote{John B. Canning commented on this diversity of terms in
the following words: "Many phrases like 'deferred charges to
operations' and 'prepaid expenses' are used interchangeably
by some accountants, others employ only one of them, and still
others, by their use of both in the same statement, imply that
a distinction is to be made. Among those whose reports imply
a distinction there is not the least semblance of uniformity
in the basis of the distinction. There is to be found in
modern procedure, however, a large number of accounts the bal­
ances of which imply that expenditures have been made in the
past for benefits which are still to be received in whole or
in part which the accountant expects will be received and will
be worth what was paid for them. These benefits may be of in­
definitely great variety but they possess certain attributes
in common: they are not capable of separate realization in
money, so long as the enterprise continues, without a simulta­
neous expense for like benefits or without incurrence of a
risk; and they all report a disposition of funds or the in­
currence of liabilities not specifically represented by either
any tangible object acquired or by any distribution to persons
having financial holdings in the concern." John B. Canning,
The Economics of Accountancy, p. 311.}
national Paper Company used the caption "Deferred Assets and Expenses" on its balance-sheet on December 31, 1951, and "Deferred Charges to Future Operations" was used in the balance-sheet of the American Can Company on December 31, 1952. The balance-sheet of the Blaw-Knox Company on December 31, 1951 shows a section captioned as "Costs Chargeable to Future Operations." In prior years, the caption for this section was "Deferred Charges." Other captions used by other companies are "Deferred Charges and Miscellaneous Unadjusted Debts" (Arkansas Fuel Oil Company), "Prepaid Expenses and Deferred Charges" (American Tobacco Company), and "Deferred Debts" (Gulf States Utilities and other utility companies). These terms have little to recommend them in preference to the more customary term, deferred charges.

Unfortunately a study of typical definitions currently offered for deferred charges provides little help in determining the true nature of the items which are placed in this classification, nor do the definitions ordinarily indicate the rather limited sense in which the term is used. As examples of prevailing definitions, the following have been selected from relatively recent accounting publications:

"Deferred charge: An expenditure not recognized as a cost of operations of the period in which incurred but carried forward to be written off in one or more future periods."  

---

"Deferred charges: Charges to be included in the determination of net income of future periods."7

"A prepaid expense or a deferred charge is an expense, service, or supply that has been acquired but not totally consumed at the close of the period, thus leaving an unexpired asset value."8

"Deferred charges are shown on the balance sheet as assets and are written off over a period of time either to Profit and Loss or to Earned Surplus. These items are nonrecurring and do not arise out of current operations; presumably, they represent expenditures that will be chargeable against future income."9

"Deferred charges represent the unamortized portion of costs and expenses incurred, which are properly chargeable against the income of subsequent periods."10

Each of the above definitions could be used to refer to deferred charges in the broad sense discussed earlier, but that is not the meaning intended by the authors. In most instances, shortly after giving the definitions, the authors then proceed to give a list of typical deferred charge items and to discuss them individually. It is only through the study of such examples that some conception of the real content of the group can be obtained, with real appreciation of the limited sense in which the term is used.

An indication of the nature and variety of the items


8Arthur W. Holmes and Robert A. Meier, op. cit., p. 7.


currently identified as deferred charges may be obtained through examination of published balance-sheets. The following examples, grouped on the basis of similar nature, have been selected from recent published balance-sheets of major companies.

**Prepaid expenses:**
"Prepaid taxes, rentals, insurance and expense."
"Prepaid insurance"
The Celotex Corporation, October 31, 1952.
"Advertising materials, stationery, etc."
Devoe and Reynolds Company, November 30, 1951.

**Organization costs:**
"Unamortized Organization, Recapitalization, and Financing Expenses"
Glass Fibers, Inc., December 31, 1951.
"Capital Stock expense"
"Debt expense"

**Development costs:**
"New route acquisition and pre-operating costs."
Mid-Continent Airlines, Inc., December 31, 1951.
"Expenses prior to operations" and "Training labor, branch plant."
The Reynolds Spring Company, September 30, 1950.
"Research and Developmental Costs--New Products and Improvements to Manufacturing Processes."
Glass Fibers, Inc., December 31, 1951.
"International Division developmental expenses."

**Relocating and transition costs:**
"Relocating costs"
Reynolds Spring Company, September 30, 1950.
"Training and other costs in connection with the Boeing fleet."
Northwest Airlines, Inc., December 31, 1951.

**Losses:**
"Flood Clearing Account--Net." (A note accompanying the balance-sheet states that this item represents the unamortized cost of parts, accessories, and other property lost or damaged in the Kansas City flood on July 14, 1951.)
Trans World Airlines, December 31, 1951.
"Losses of a Philippine subsidiary."
The General Public Utilities Company,
December 31, 1949.

"Extraordinary property losses of subsidiaries (being amortized)."

Debt discount and unamortized discount and call premium:
"Debt discount and expenses applicable to refunded issues"
"Unamortized debt discount and expense"
The Quaker Oats Company, June 30, 1952.
"Unamortized redemption premium and expense on debt."

Many published balance-sheets today do not list individual items in the deferred charges section. Instead, they show a single item, "Deferred Charges" or similar caption, and a single amount. Of 242 published balance-sheets which were examined as a part of this study, 173 were found to have deferred charges. Of the latter, 106 showed a single, collective item without giving any detailed information as to the items included in the total. For this reason, current accounting literature (see Bibliography) has served as the primary guide for the selection of the major items to be analyzed in this study.

For balance-sheet presentation, the deferred charges section (or collective item) is almost invariably shown as

11"Unquestionably 'deferred charges' has an established place in the lexicon of accounting, but it may be unwise, because of the varied character of such charges to include large items under this caption without at least a general indication of their nature." Editorial, Journal of Accountancy, LXX, (1940), 4.
the very last of the asset items on the balance-sheet. Of
the 173 reports examined which had deferred charges, 129
showed the deferred charges at the bottom of the asset group.
The reason for this location in the balance-sheet is not
clear. It may be due to the lack of liquidity of deferred
charges. In many balance-sheets the assets are arrayed in
the order of liquidity with the most liquid items listed
first. In such a case, the deferred charges might justifi-
ably be considered as the least liquid of the assets and
therefore listed last. However, on balance-sheets where the
assets are arrayed in inverse-liquidity order, the deferred
charges are frequently shown as the final asset group.

Perhaps the location is due to the fact that some
accountants are reluctant to recognize deferred charges as
assets at all and will admit them to the balance-sheet only
in the most inferior position. Arnold W. Johnson states
that: "Deferred charges, if any, should be shown as a final
grouping on the asset side of the balance sheet. As a matter
of fact, deferred charges (narrowly defined) are not assets
at all. However, they sometimes are admitted to the balance
sheet on the grounds no better than the questionable one of
expediency."12 Kennedy and McMullen state that "for analytical
purposes, deferred charges (exclusive of prepaid expenses)

12 Arnold W. Johnson, Elementary Accounting (New York:
are generally discounted heavily, since their value is conjectural."

The above definitions, examples, and citations show clearly that, as customarily presented in the balance-sheet today, the deferred charges section is a catchall section in which are placed a variety of heterogeneous items which possess no common characteristics which might logically serve as a basis for classifying the items together. The caption of the section, Deferred Charges, is vague, giving no useful indication of the nature of the items placed within the section. Even the location of the section in the balance-sheet does not appear to be the result of any logical reasoning.

In the light of the above conditions, it is not surprising that the deferred charges section is viewed with considerable doubt and suspicion by many individuals who use the balance-sheet, even to the extent of complete elimination from the assets by many analysts. It is clear that the deferred charges section is a meaningless section, serving little or no useful purpose.

The following chapters of this study contain recommendations as to more meaningful and useful presentation of the items customarily presented in the deferred charges section. One result of these recommendations would be the elimination of the deferred charges classification completely.

13Kennedy and McMullen, op. cit., p. 85.
CHAPTER IV

PREPAID EXPENSES

THE NATURE OF PREPAID EXPENSES

"Prepaid expenses" is customarily used in accounting as a collective term embracing expenditures made for items such as office and store supplies not yet consumed, advance premium payments on insurance policies, advance rental payments, and prepaid interest. Other items are sometimes found but the above may be considered as typical prepaid expenses. For statement purposes, if the individual items are immaterial in amount they are usually combined and the total identified simply as prepaid expenses. Any items which are material in amount are usually listed individually.

In attempting to select a satisfactory definition for prepaid expenses, somewhat the same problem is encountered as was found in the search for a good definition for deferred charges. In many instances, particularly in writings prior to 1940, prepaid expenses and deferred charges are defined together and used interchangeably.¹ Some of the more recent

¹Typical examples are as follows: "A deferred asset, or prepaid expense, is a supply or service purchased but not consumed at the date of the balance sheet. Deferred assets represent services paid for in advance, such as rent paid in advance, insurance paid in advance, prepaid advertising, and prepaid interest. On the other hand, a deferred asset or prepaid expense sometimes includes tangibles such as stationery, stamps, and supplies." Earl A. Saliars and Arthur W. Holmes, Basic Accounting Principles (Chicago, Business Publications, Inc., 1939), p. 28.
writings do attempt to make some distinction between the two
terms, probably as a result of the influences mentioned later
in this chapter. The most recently published accounting
dictionary in the United States, however, defines a prepaid
expense as "An expenditure, often recurrent, for benefits
yet to be received: a type of deferred charge." 2

THE DETAILED ACCOUNTING PROCEDURE FOR PREPAID EXPENSES

Prepaid expenses are initially recorded in the accounts
at cost. This cost is determined by the acquisition trans-
action. Office supplies are recorded at the amount of the
expenditure required for their acquisition; prepaid rent is
recorded at the amount paid by the enterprise to the land-
lord; prepaid insurance is recorded at the amount of the
advance premium paid to the insurance company. These costs
in the accounting records represent the benefits of services
deemed to have been acquired by the enterprise—supplies

"Deferred charges to expense represent commodities and
services that have been purchased for consumption but are
unconsumed at the end of the fiscal period. Although such
items are purchased and paid for in one period, they will
not become expenses until consumed in a subsequent period.
They are therefore frequently termed prepaid expenses."
James O. McKinsey and Howard S. Noble, Accounting Principles

"In case an expense bill which is paid in one year
belongs either in part or in whole to the following year, it
is necessary to carry the amount prepaid forward as a 'Deferred
Charge to Operations.' The prepaid expense is then applied
to the period to which it belongs. Illustrations of expenses
which are frequently paid in advance are insurance, taxes,
interest, and commissions." Dewitt Carl Eggleston, Auditing

2 Kohler, op. cit., p. 325.
which will benefit the business as they are consumed, service through the use of the property being rented for the term covered by the advance rental payment, protection service afforded by the insurance for the term of the premium.

These costs, once entered in the records, are then amortized periodically. The method of determining the amount to be amortized depends to some extent on the nature of the item. For some, such as insurance and rent, whose service is rendered on a time basis, the amortization is based on the elapsed time. For example, if $1,500 is paid to the landlord for rent in advance for fifteen months, the expenditure can then be recorded in an asset account entitled "Prepaid Rent." If accounting statements are to be prepared at the end of the ninth month of the term, the amount to be amortized from the prepaid rent account would be $900, leaving $600 in the prepaid rent account to represent the unexpired term of the rental period. In other cases, as with supplies, where benefit is derived through physical consumption, the amount of amortization is based on the consumption which has taken place. In some cases it may be necessary to determine the amount consumed by considering the total acquired and the amount remaining at the end of the period for which the determination is being made. For example, if $400 is paid for office supplies, that amount can immediately be entered in an asset account representing the office supplies. As the supplies are consumed it will usually be impractical to record the consumption each day. If it is found that $100 of the supplies remain unconsumed
at the time statements are being prepared, it is clear that $300 should be amortized from the asset account for supplies, leaving $100 in that account to represent the unconsumed supplies at that time. With respect to the amounts of prepaid expenses being amortized, in some instances the amortization is just a transfer from one asset account to another, to rest there temporarily before assignment as expense. For example, in the case of a manufacturing enterprise, the portion of some prepaid expenses being amortized is recognized as manufacturing overhead, assignable to the product being produced, ultimately assignable as expense when the product is sold.

It is believed that the above description, though brief, is a reasonable statement of the detailed accounting procedure usually followed today for prepaid expense items. It is interesting to note that the procedure is strongly influenced by several of the basic concepts presented in Chapter II. The expenditures are recorded at cost—measured consideration. The cost elements are held in suspense until time for proper matching against revenues. During the time they are held in suspense they are considered to be susceptible to regrouping and assembling with other costs. There seems to be no violation of basic concepts in this procedure, and on the basis of the analysis thus far there appears to be no cause for criticizing the customary
accounting treatment of prepaid expenses. 3

BALANCE-SHEET PRESENTATION OF PREPAID EXPENSES

Traditionally, prepaid expenses have been classified in the deferred charges section of the balance-sheet, as far as possible away from the current asset section. In a study of published balance-sheets of 525 companies for the year 1946 it was found that 96% of them displayed prepaid expenses in this manner. 4 However, in a similar study of balance-sheets for the year 1950 it was found that only 65% showed prepaid expenses classified in this manner. 5 This decline was the result of many firms shifting the prepaid expenses up to the current asset section. If this trend continues it will not be long (if the time has not already come) before it can safely be stated that the prevailing practice is to classify prepaid expenses in the current asset section. It may be well to consider now the causes for this change in classification.

The change is not so much the result of a change in attitude toward prepaid expenses as it is the result of a change in attitude toward current assets. Until fairly recent years most accountants would have stated without

3 It may be well to note at this point that the author intends to take complete exception to the recognition of "Prepaid Interest" as a prepaid expense item. The discussion of this will come at a later point in this chapter.


hesitation that current assets consist of cash and other assets which will be converted into cash relatively soon, generally speaking within one year. This concept of current assets would clearly include such items as cash on hand, cash on deposit in banks, ordinary accounts and notes receivable, and merchandise held for sale. Certain other items such as marketable securities and cash surrender values of life insurance policies are not so clearly includible but were usually placed in the current asset section in actual practice. Items which would not be converted directly into cash, such as prepaid insurance, prepaid rent, and the other prepaid expense items, were excluded from the current asset classification. This concept of current assets shows very definite influences of a liquidation attitude. This attitude is still held by many accountants, as indicated in the following fairly recent statement by an accountant who says that prepaid expenses have no place in the current asset section of the balance-sheet.

"We accord them a separate title under the general term 'assets,' and usually as the last item under the assets. It is contrary to all principles of reason (whether accounting or other) to classify an item, which has no salvage value, as a current asset, even though the item was paid for on the last day of the fiscal period.... Current assets should be assets that are available for conversion into cash with which to liquidate liabilities."6

This attitude by accountants is probably the result of the "pounce" approach formerly taken by most credit-grantors.

---

Prime consideration was given to the current position of the business from the standpoint of what assets were available for immediate conversion into cash, if need be. The current assets, and the ratio of current assets to current liabilities were deemed to be the most significant measures of the debt-paying potential of the enterprise.

In recent years creditors have changed their attitude. Even short-term creditors now tend to rely more on the ability of the enterprise to pay its obligations out of proceeds of current operations and less upon ability to pay in case of liquidation. The shift is from that of a liquidation attitude to that of a going concern attitude. This shift has led to a significant change in the concept of current assets. Instead of considering the current asset section as a pool of cash and near-cash items, the trend today is to let the current asset section display the "working capital" assets of the enterprise.\footnote{Because of the variety of ways in which it is commonly used, the term working capital should be used with care. It will hereafter be used to refer exclusively to assets. "Net working capital" will be used, if necessary, to refer to the excess of total working capital over current liabilities.} In so doing, a fundamental inconsistency that existed in former balance-sheets is avoided--assets are more nearly presented on a going concern basis instead of some being presented on that basis and others being influenced by the liquidation attitude. In addition, a vital element of the enterprise, working capital, is shown...
more clearly than formerly.

A clear understanding of what is meant by working capital is necessary if current asset items are to be classified on that basis. The total capital employed in a business can be divided into two parts, fixed capital and working capital. The latter is variously referred to as current capital, circulating capital, and liquid capital. The fixed capital is that which is invested or reserved for investment in the facilities with which the business is conducted: land, buildings, machines, showroom fixtures, delivery equipment, and even intangibles such as patents, copyrights, and leaseholds. In most cases the fixed capital assets are gradually exhausted, either physically or functionally, as they are

---

8 Dewing, who used the term "current capital" in the same way that working capital is here being used, states that every business consists of three elements. "These elements are the fixed capital, the current capital, and organization—the latter created by and dominated by the human skill of management." Arthur Stone Dewing, The Financial Policy of Corporations (Fourth Edition, New York: The Ronald Press Company, 1941), II, 706.

9 Dewing points out that the idea of showing working capital clearly is not new. "The differentiation between fixed and current capital is practically as old as corporation accounting among the Anglo-Saxon nations. In 1571 the stockholders of the Society of the Mines Royal, having become dissatisfied with the failure of the management to pay dividends, refused further subscriptions. To encourage the stockholders, an inventory or balance sheet was prepared entitled 'An Estimate of the Stock Remaining at the Mines and the Value thereof at Christmas last.' This is one of the first English corporate or joint stock balance sheets in existence. The capital is entered under three headings which might be described as inventories, the current capital used in the business, and the fixed capital. It shows a clear conception of the difference between current capital and fixed capital...." Ibid., p. 707.
used in the operation of the business. As this takes place it may be said that, in a sense, they are gradually converted into cash.

In addition to fixed capital, an enterprise usually needs capital for meeting the day to day expenditures necessary for carrying on the business. Employees must be paid, materials must be purchased, supplies are needed in carrying on the operations, protection in the form of insurance must be provided, taxes must be paid, and so on with innumerable expenditures which must be made in addition to those made in the acquisition of the major facilities of the business. The part of the total capital which is employed in this way is referred to as the working capital.

A distinct cash-cycle can be observed in connection with the working capital items. First, cash is expended for goods and services. These costs then become embodied, directly or indirectly, in the product being produced. The finished product is then sold, possibly on credit. The customers then normally pay within a specified period. Thus the cycle from cash to cash is completed.\(^\text{10}\) The duration of this cycle is

\(^{10}\)It should be recognized that the cash realized at the completion of the cycle is usually greater than the cash put into the cycle. The excess may be due, in part, to partial conversion of fixed facilities into cash, as indicated above, and in part, to the profit arising because selling prices were greater than the aggregate of expenses. Assuming stable conditions, both of these parts will probably not remain in working capital long, nor should they. The part relating to facilities should be reinvested in replacement facilities. Even if this is not done immediately this cash should be reserved outside of working capital for such replacements, otherwise excess working capital will result. The cash relating
fairly short in comparison with the cash-cycle for fixed
capital. To a large extent its length depends on the nature
of the specific business. In current accounting literature
and practice, the cash-cycle for working capital assets is
usually referred to as the "operating cycle" of the enter-
prise, and it is in this sense that the term operating
cycle will be used hereafter in this study.

Although some accountants had advocated the working
capital approach to the problem of current asset classifica-
tion, it was not until 1947 that any definite trend in that
direction was manifested. In the fall of that year the
Committee on Accounting Procedure of the American Institute
of Accountants unanimously recommended the following defini-
tion for current assets. "For accounting purposes, the
term current assets is used to designate cash and other
assets or resources commonly identified as those which are
reasonably expected to be realized in cash or sold or con-
sumed during the normal operating cycle of the business."11

---

11 The committee elaborated on this definition in the
following words: "Thus the term comprehends in general such
resources as (a) cash available for current operations and
items which are the equivalent of cash, (b) merchandise or
stock on hand, or inventories of raw materials, goods in
process, finished goods, operating supplies, and ordinary
maintenance material and parts, (c) trade accounts, notes,
and acceptances receivable, (d) receivables from officers
(other than for loans and advances), employees, affiliates,
The two features of this definition which distinguish it from earlier ones are its admission of assets which are not expected to be realized in cash but which will be consumed within a certain period, and its use of the operating cycle for determining the period rather than using the twelve-month period without regard to the nature of the business.\(^{12}\)

Although there was much opposition to this definition at the time it was first published and some accountants still do not accept it, there has been wide acceptance of it in the past few years; it seems destined to set the pattern for current asset classification in the future.

In concluding this section dealing with the balance-sheet presentation of prepaid expenses, it may be well to recapitulate. The traditional classification of prepaid expenses has been as deferred charges, and as indicated by recent statistics,

---

and others if collectible in the ordinary course of business within a year, (e) installment or deferred accounts and notes receivable if they conform to normal trade practices and terms within the business, (f) marketable securities representing the investment of cash available for current operations, and (g) prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance, would require the use of current assets during the operating cycle. "Accounting Research Bulletin No. 30 (New York: American Institute of Accountants, 1947), p. 248.

\(^{12}\) The committee does make provision for some exceptions to the use of the operating cycle. "A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within such time period. However, where the period of the operating cycle is in excess of twelve months, such as in the tobacco, distillery, and lumber businesses, the longer period should be used." Ibid., p. 249.
probably a bare majority of accountants continue to classify prepaid expenses in this manner. This classification is largely the result of the former attitude of credit-grantors and reflects a liquidation viewpoint rather than a going concern viewpoint. In recent years there has been a definite trend toward the classification of prepaid expenses in the current asset section. This trend is directly the result of the recommendation of the committee of the American Institute of Accountants which gives recognition to the changed attitude of credit-grantors, the need for clear statement presentation of that significant element of the enterprise, working capital, and the desirability of a consistent going concern viewpoint in the preparation of all parts of the balance-sheet.

It is therefore concluded that the classification of prepaid expenses as deferred charges is not in conformity with basic accounting concepts, and it is recommended that prepaid expenses (except for prepaid interest) henceforth be classified as current assets.

PREPAID INTEREST

One of the items customarily identified as prepaid expense in current accounting practice is prepaid interest. Many leading writers likewise refer to prepaid interest as being a prepaid expense.\(^{13}\) However, there are some accountants who maintain that interest cannot be "prepaid" in the

same way that items such as insurance and rent are prepaid.14

A typical explanation of how prepaid interest arises is as follows: Assume that a firm executes a non-interest bearing note for $1,000, payable in sixty days. This note is then discounted at a bank at a discount rate of 6%. The net proceeds received by the enterprise is $990 and the $10 deducted by the bank is deemed to be interest paid in advance, hence "prepaid" interest. The explanation might go on to point out that the transaction with the bank may be divided into two parts. In one part the bank gives the borrower $1,000 in exchange for the note of that amount due in sixty days. In the second part the borrower immediately pays to the bank $10 as interest for the term of the note.

In accordance with the above reasoning, at the time the note is discounted the accountant would record a liability of $1,000 with respect to the note and an asset of $10 relating to the prepaid interest. This asset, prepaid interest, will be deemed to expire as the term of the note passes. Thus, if statements are prepared at the end of one month, $5 of it would be reported as Interest Expense and $5 of it would be reported on the balance-sheet as the residue of the asset, prepaid interest. The balance-sheet would also contain a liability item, note payable, in the amount of $1000, as initially recorded. If statements are prepared again at the end of the term of the note, but just before the note is paid,

$5 would be reported as interest expense relating to the second month and nothing would be shown on the balance-sheet as prepaid interest remaining. The liability of $1,000 would be shown on this balance-sheet just as it was on the preceding one.

Careful analysis will show that the above treatment of interest is unsound. Interest is a charge for the use of money. In the above case the borrower did not really borrow $1,000 at the outset. The bank allowed him the use of $990 with the understanding that he repay it, plus $10, at the end of sixty days. The $10 is interest which really accrues during the term of the debt. It was not paid in advance at all. In fact, it does not get paid until the very end of the term of the debt.

The customary accounting procedure for cases such as the one outlined above not only results in showing as an asset (prepaid interest) something which is not an asset in any reasonable sense of the word, but it also fails to adhere to the basic accounting concepts of the going concern and measured consideration in accounting for liabilities. At the beginning of the term of the note, the amount to be recognized as the liability should be $990 (the amount borrowed). This amount is determined by the measured consideration in the transaction between borrower and lender. The amount to be recognized as liability at any later date should be $990 plus the portion of the $10 interest accrued to that date. To require the recognition of a liability of $1,000 at any time prior to the maturity date of the note is
to adopt a liquidation attitude rather than that of a going concern.

In view of the weaknesses in the customary treatment of interest in cases such as the one described above, the following recommendations are offered. The amount to be recorded as the liability at the time the note is discounted should be the net proceeds received. No amount should be recorded as prepaid interest. The difference between the amount received and the total to be paid at the maturity date represents the interest charge for the use of the net proceeds during the term of the note. This amount should be accrued during the term of the note so that at maturity date, just before the note is paid, the sum of the amount borrowed (net proceeds initially recorded) plus the interest accrued thereon will correspond with the amount to be paid at that time according to the contract. In preparing statements at any intermediate time, the amount to be shown as liability on the balance-sheet is not the amount to be paid at maturity but rather the amount initially borrowed plus interest thereon accrued to-date.
CHAPTER V

ORGANIZATION COSTS

THE NATURE OF ORGANIZATION COSTS

No new business enterprise is able to begin operations instantaneously on a normal operating basis. A preliminary period is always necessary. For some enterprises this preliminary period is brief; for others it may be long and costly. In any case, a variety of costs may be incurred during the preparatory period. Expenditures are made for the acquisition of the tangible facilities which will be employed in the activities of the enterprise. Buildings, machinery, furniture and fixtures may be required. Expenditures may also be made for the acquisition of facilities of a more intangible nature but which are necessary for the life of the enterprise. Patents, copyrights, trademarks, and leaseholds may be acquired. In addition to the expenditures which are clearly assignable to specific tangible and intangible acquisitions, other expenditures are usually necessary during the preliminary period. Although the latter expenditures may not be definitely assignable to any specific properties acquired by the enterprise, they nevertheless represent necessary costs of getting the enterprise ready to carry on its regular operations. In many cases such expenditures are quite varied and are often of substantial amount. The promoters of the enterprise expect to receive compensation for their services as well as reimbursement for
expenditures they have made in behalf of the enterprise.
Legal, engineering, and accounting services are often re-
quired. In the case of the corporate form of organization,
incorporation fees, prospectus costs, and printing and
engraving costs will be incurred. Underwriters' commissions
and other costs of securing capital must be paid. It is
to expenditures such as these that the term "organization
costs" commonly refers.

THE TRADITIONAL ACCOUNTING TREATMENT OF ORGANIZATION COSTS

"The traditional attitude of accountants toward
organization expenses is that they are a sheer
loss, and that there is no theoretical justification
for any treatment other than writing them off as
soon as possible. However, since such a treat-
ment would create a deficit before the company
began operations, accountants have sanctioned
carrying organization expenses as a deferred charge
to be written off to Earned Surplus during the
early years of the company's life."3

The above quotation from the most recent edition of one
of the most popular textbooks in the field of accounting

1The variety of such costs is suggested in the follow-
ing statement by Burchett: "The feast and orgies of court
life in the Middle Ages could be put to shame by comparison
with the entertainment used in some promotions. Hotel
suites, dinners, banquets, yacht parties, drunken bouts and
lewd practices all are combined for the one purpose of
seducing the proper agencies to accomplish the ends in view.
Why such practices are tolerated and even looked upon with
condonation, seems difficult to comprehend in a state of
supposedly advanced civilization such as that of which we
boast." Floyd F. Burchett, Corporation Finance, (New York:

2The term "organization expenses" is often used today
in the same sense in which "organization costs" is used in
this discussion. The use of the former term for identifying
expenditures which should appear in the records as assets,
not as expense, is confusing.

3Finney and Miller, op. cit., p. 509.
states very clearly the current attitude of many accountants toward organization costs. Other authorities have expressed the same thoughts with but slight variations.

In addition to noting the traditional attitude of accountants toward organization costs in general, it may be well at this point to consider the customary accounting treatment of three specific items to which exception will later be taken.

It is common practice in corporation accounting today to deduct all expenses incurred in the issuance of capital stock from the total proceeds received from the subscriber and then to record the net proceeds remaining as the investment made by the stockholder. In some instances the offsetting takes place at the time the stock is issued. In other instances the same effect is obtained by writing off such expenses

4 "It is an undesirable item on any balance sheet.... Its write-off should therefore be accomplished as rapidly as net profits will permit, usually over a maximum of, say, 3 years." Roy B. Kester, op. cit., p. 371.

"In general accountants have been reluctant to admit 'organization expenses' to the family of respectable assets. It is usually agreed, however, that it is proper to handle this class of expenditure as a deferred charge subject to early amortization." W. A. Paton, Editor, Accountants' Handbook (Third Edition, New York: The Ronald Press Company, 1949), p. 128.


"In actual practice both accountants and business men are glad to get such doubtful items out of their balance sheets and usually write them off as rapidly as the amount of earnings or surplus will permit." Kenneth MacNeal, Truth in Accounting (Philadelphia: University of Pennsylvania Press, 1939), p. 238.
against paid-in surplus.⁵

A somewhat similar practice exists in the treatment of issuance expenses for bonds issued by a corporation.⁶ The total of the proceeds received from the bond subscribers is reduced by the amount of issue costs such as legal fees and printing costs. The difference between the amount of net proceeds thus obtained and the maturity value of the bonds issued is recorded as premium or discount on the bonds. In so doing, bond issue costs will not appear as such in the records and statements of the corporation but will be reflected indirectly in the premium or discount shown for the bond issue.

A third common practice of accountants with regard to organization costs is to refuse to recognize any additions to organization costs once the operations of the enterprise have begun and profits are sufficient to absorb such expenditures. In accordance with this practice, any financing

⁵"Selling expenses and commissions on issues of capital shares may be charged against paid-in surplus created from the proceeds of the issue, against paid-in surplus created from proceeds of issues or shares no longer outstanding, or against earned surplus. These selling expenses and commissions may include commissions to selling agents; commissions or discounts allowed to underwriters; attorneys', engineers', or accountants' fees; printing costs; S.E.C. filing fees; and other expenses clearly and directly attributable to realization of proceeds of the shares issued." Robert H. Montgomery, Norman J. Lenhart, Alvin R. Jennings, Montgomery's Auditing (Seventh Edition, New York: The Ronald Press Company, 1949), p. 391.

⁶"It is common practice to lump actual discount with the legal fees, printing costs, underwriting commissions, and other charges associated with the issuing of bonds, but this is not good accounting." W. A. Paton, Advanced Accounting (New York: The Macmillan Company, 1947), p. 612.
costs relating to additional stock issuances and any other costs relating to an expansion program which cannot be clearly identified with specific properties would be written off immediately rather than capitalized in an asset account.

It is of interest to note that in those cases where organization costs have been admitted to the accounts and are to be presented in the balance-sheet, accountants are not in complete accord as to the section of the balance-sheet in which they should appear. Of fourteen leading writers surveyed in this study, eight preferred the deferred charges classification, four preferred the intangible asset classification, one preferred to classify organization costs as other assets, and one would show organization costs separately on the statement, immediately following the tangible assets. Although this survey was by no means exhaustive, it is perhaps safe to state that where organization costs are presented on the balance-sheet, many accountants (perhaps the majority) would classify them in the deferred charges section. When so presented, there is usually no effort to identify the individual costs which make up the total shown as organization costs.

CRITICISM OF THE TRADITIONAL ACCOUNTING FOR ORGANIZATION COSTS

The traditional accounting treatment of organization costs is subject to criticism in several respects. The most obvious is the unreasonably skeptical attitude taken by accountants toward these expenditures. This skeptical attitude is due in large measure to the impossibility of
identifying the general organization expenditures with specific tangible properties. Accountants do not hesitate to record an expenditure for machinery as an asset, a cost to be spread as expense over future periods which will receive benefit from the machinery. Likewise, they do not hesitate to record the cost of labor employed in installing that machinery as an addition to the asset, also to be spread over the periods benefited by the machinery. The latter costs are clearly necessary in getting the machinery in position to render benefits and they can easily be identified with the machinery. However, these same accountants look with suspicion upon expenditures which are made to create the organization which later acquired the machinery. Are not these expenditures just as necessary for carrying on activities in future periods as the expenditures which are directly traceable to tangible properties? If an attempt were made to array costs in the order of their importance, would it not be reasonable to rank the organization costs above those related directly to the machinery? Without them the entity which acquired the machinery would not be in existence and it is the entity for which the entire accounting process is designed.

---

7"As incurred, all classes of costs are on an equal footing, without regard to the ease with which they may be assigned to specific tangible objects, although they vary sharply with respect to the rate at which they may be absorbed in charges to revenue." W. A. Paton and A. C. Littleton, op. cit., p. 33.

8"With the entity concept as a basis, there is no difficulty in accepting the proposition that all costs legitimately incurred by the enterprise are properly included, in the first instance, in the total of assets. Thus organization expenditures, costs of raising capital, and related charges are elements of enterprise assets and capital." Ibid., p. 9.
The skeptical attitude of accountants toward organization costs is due, in part, to the fact that organization costs do not usually possess any realizable value. But such an attitude is in conflict with the going concern concept which provides that the accountant should view assets not from the standpoint of how much cash can be realized immediately from their sale but rather from the standpoint that those assets measure the effort which has been dedicated by the enterprise toward the production of future revenue. It is only from this standpoint that the accountant can justify capitalizing the cost of installing machinery. Such installation costs do not increase the liquidation value of the machinery; more than likely they tend to decrease the realizable value by making the machinery less mobile. Even so, they are customarily recorded as capital expenditures for they represent efforts dedicated to the production of future revenue through the use of the machine. If there is reasonable expectation that such revenue will be forthcoming they should be presently capitalized in an asset account and then matched against those revenues as they materialize in the future. Consistency and logic would require that the same attitude be taken toward all expenditures made by the enterprise, even though no value

---

9"On the other hand, unless the expenses of organization are written off during a certain number of periods, the balance sheet will forever contain an asset which has no salable value and which does not in any way tend towards the proper presentation of the financial status." Paul-Joseph Esquerré, The Applied Theory of Accounts (New York: The Ronald Press Company, 1914), p. 317.
immediately realizable in cash results from the expenditures.  

To look with disfavor upon organization costs simply because they do not represent any realizable value is to adopt a liquidation viewpoint and to abandon the going concern concept which is basic in accounting today.

The present skeptical attitude of accountants toward organization costs may be partially due to the fact that such costs have been subject to overstatement and abuse by unscrupulous promoters in the past. In recent years there has been a sharp decline in such practices, largely as a result of regulatory laws and agencies. It is improper to impugn the class of expenditures as a whole simply because a few are of doubtful validity. This is not to say that all expenditures made during the period of organization can safely be capitalized without any questioning.  

Losses may occur during the period of organization as well as at any later time. All expenditures, including organization costs, should be judged on their

10It must be kept in mind, however, that neither lack of specific assignability nor legal availability for paying debts warrants the conclusion that the costs in question represent balance-sheet items of doubtful propriety." Paton and Littleton, op. cit., p. 32.

11Kester is rather rash when he says: "It is sufficient to say here that upon their incurrence organization expenses constitute capital expenditures, for no revenues are available to absorb them." Kester, op. cit., p. 21. This statement seems to say, in effect, that all expenditures made when no revenues are available to absorb them are automatically to be considered as assets. (On page 19 of the same book Kester describes capital expenditures as those which result in charges to some asset accounts.)

12The complete consideration of losses is deferred until a later chapter in this study.
merits and in the light of existing conditions. Professor Paton has suggested the following test for determining the propriety of capitalizing organization expenditures: "Does the cost in question represent the price of a commodity, service, or condition necessary to the initiation of the enterprise, and was the price paid a legitimate one under all the circumstances?" Affirmative answers to both parts of the question are required to justify capitalization.

The traditional accounting treatment of organization costs shows a complete disregard for the concept of matching cost and revenue. The general attitude seems to be to get the expenditures written off the books as soon as possible, either immediately or at least over the first three to five years of life of the business. From the standpoint of good accounting theory, an immediate lump-sum write-off of an asset is tantamount to saying that future periods will receive no benefit from that particular asset. Likewise, if an asset is being amortized over a three or five year period the implication is that there is good evidence that those years are the ones which will receive the major benefit from the asset. In the first case, since no future revenues attributable to the asset are anticipated, the immediate removal of the amount from the suspense category (asset) is justified. In the second case, the periodic amortization affords a proper matching of costs and revenues. However, this does not seem to be the reasoning followed by those who advocate the early

---

write-off of organization costs. It would be absurd to maintain that the enterprise will derive no benefit whatsoever in future periods as a result of the organization expenditures. Were it not for these expenditures the future periods, as far as the enterprise is concerned, could never come to pass. It would be equally absurd to maintain that the first few years of life of the enterprise receive more benefit from the organization costs than the remaining years.

It is probably true that those who advocate the early write-off of organization costs do not really attempt to maintain either of the positions stated above. Instead, when pressed for an explanation, they must admit that in advocating the early write-off of organization costs they are really abandoning the concept of matching cost and revenue. In its place they are substituting a practice of arbitrarily writing off costs as rapidly as possible without creating any deficit for the enterprise. When asked to justify this procedure, "conservatism" would probably be raised as one defense—the asset is intangible, of use only to a going concern, with no realizable value in the event of liquidation. But, as soon as this argument is advanced, those who advance it must then plead guilty to the violation of two other basic concepts. They have abandoned the going concern concept in this area of their accounting, and since they have not abandoned it in all areas they are immediately guilty of violating the concept of consistency. If costs relating to intangibles are to be written down to realizable values, consistency would dictate similar treatment of the
costs relating to tangible assets such as machinery. Such treatment is not recommended even by those who recommend the early write-off of organization costs.

A different explanation which might be offered for the arbitrary write-off of organization costs involves the concept of immateriality. In some cases the amount of the organization costs incurred is fairly small in relation to the total assets employed by the enterprise. It may be argued that little distortion will result from an arbitrary write-off of such immaterial amounts, and that no one will be misled by their absence from the assets shown on the balance-sheet. In such cases it may be more expedient to write off the costs arbitrarily rather than to carry them indefinitely or to pursue a program of periodic amortization if the term of usefulness is definitely known. This argument seems to have much more justification than the former argument of conservatism, but it should be emphasized that it is justifiable only when the amounts are so small that no one will be misled by reports prepared on this basis.

Even if the arbitrary write-off of organization costs of immaterial amounts is justified, the question still remains as to what should be done in those cases where the amounts are material. No single brief statement can answer this question adequately. Each expenditure should be considered on its merits and in the light of conditions existing at the time.\(^1^4\) Some

\(^{14}\)To facilitate this it would be well to record the various types of organization expenditures separately rather than to merge them all in a single organization expense account as is commonly done today.
expenditures may, after careful analysis, be deemed to be of indefinite usefulness. The costs of obtaining the charter and similar costs in creating a corporation which appears to have an indefinite life are of this type. They may be compared with the cost of a plot of land which is being used as a building site which has indefinite usefulness and which is therefore not subject to depreciation. In some cases the useful period of organization costs may be limited because of a limited useful life of the enterprise to which they relate. The business may be created with the expectation of being continued for only a limited time—until certain mineral resources are removed, for the duration of a limited franchise, or until some other period has elapsed or some purpose fulfilled. In such instances the amortization of general organization costs over the limited period is necessary in order to attain a proper matching of costs and revenues. In some instances there may be indicated the need for the write-off of some general organization costs, in full or in part, which were originally deemed to be of unlimited usefulness. If the enterprise suffers a material and permanent contraction of its scale of operations, the write-off of organization costs commensurate with this retrenchment is necessary. If an enterprise is operating several branches or divisions, the general

15 "In Italy, where corporate life is limited to 50 years, it is prescribed that organization costs be prorated over the full life of the corporation." Kester, op. cit., p. 371. In some states in the United States corporate charters are granted for only a specified term. However, because of the ease of renewal, this does not place any real limitation on the life of the corporations operating under such charters.
organization costs identifiable with a given branch or division should be written off in the event of discontinuance of that branch or division. Financial costs relating to a specific security issue should be written off in the event of retirement of that security issue. Financing costs relating to a security issue which has a definite life should be amortized periodically over that lifetime.

In an earlier section of this study mention was made of the traditional accounting treatment of the expenses incurred in the issuance of stock. The procedure with respect to these expenditures is questionable. The amount invested in the enterprise by its stockholders is not diminished by the applications made by the enterprise of those funds. If a certain subscriber subscribes to 100 shares of stock at 105 and pays that amount to the corporation, thereupon receiving his stock, the amount which he invested in the enterprise is $10,500. The fact that the corporation had to pay $100 in engraving costs, salesman's commission, and similar issuance costs does not mean that the investment of the subscriber has been reduced to that extent.\(^\text{16}\) The amount contributed by the subscriber should be recorded as the invested capital of the enterprise. The stock issue costs should be recognized.

\(^{16}\) "The amount invested by the stockholder is not diminished by the cost of services of any kind needed to launch the business.... The fact that some service costs are more closely associated with the investment process than other charges doesn't render such costs any less valid.... Only where unwise or unfortunate expenditures have been made, during a normal reading process, is there any justification for taking the position that a portion of the total invested has been dissipated." Paton and Paton, op. cit., p. 469.
as bona fide organization expenditures and recorded as such.

A quite similar criticism can be leveled against the customary treatment of bond issue costs. Such costs should be recorded as organization or financing costs and identified separately from any premium or discount on the bond issue arising because of a difference between the contract interest rate and the prevailing market interest rate for such bonds. The financing costs should be recognized as valid assets, just as other organization costs, and should be accorded the treatment suggested above for such organization costs.

The common practice in accounting today of refusing to recognize any additions to organization costs once the enterprise begins operations is also subject to criticism. After an enterprise has become firmly established, expenditures similar to those incurred in the initial organization of the business are often incurred. The established business may decide to open a new branch. The business may decide to enlarge and diversify its operations by the addition of new products or lines for which new plants, personnel, and capital

---

17 It must be admitted that in some cases where bonds are issued through an investment banker, no sharp distinction is made between bond issue costs and discount. Such difficulty can be removed by following the suggestion of Paton: "It is desirable ... that arrangements be made with all financing agents in such a manner as to make it entirely clear as to what services are to be rendered and what amount is to be paid for such services. Preferably the entire amount of all funds invested by those actually providing the funds should be turned over to the corporation and all costs incurred should be paid for explicitly from the corporate treasury." Ibid., p. 471.

18 Complete discussion of the accounting treatment of bond discount is deferred until a later chapter in this study.
may be required. Just as in the case of the original organization, most of the expenditures for such expansion can be identified with specific properties acquired and are accordingly properly capitalized in asset accounts identified with those properties. It is probable that some valid and necessary expenditures will be made which cannot be so identified but which are comparable to the organization costs recognized at the inception of the enterprise. Should such expenditures be written off immediately simply because no deficit will result from so doing because of present profits or profits accumulated from past periods? To do so would no doubt be consistent with the prevailing attitude of many accountants toward such expenditures incurred at the time of original organization, and the same criticisms which have been stated above can be applied here as well. These expenditures should, instead, be capitalized in appropriate asset accounts at the time they are incurred and should then be subjected to periodic amortization, lump-sum write off, or carried indefinitely in accordance with the procedure recommended above for original organization costs.

The prevailing accounting treatment of interest costs during the period of organization is also subject to criticism. No mention of this problem has been made before in this discussion because the prevailing practice does not identify such interest with organization costs. The problem arises in the case where a corporation, before it has begun operations, has issued bonds which bear interest at a stipulated rate.
How shall the interest accruing during the period prior to normal operations be recorded?

The customary accounting treatment of interest costs during the period of organization is to identify the interest cost with the specific tangible assets being constructed or acquired during the organization period with the funds provided by the bond issue. The reasoning is that since the bonds were issued to finance the acquisition of those properties, any interest incurred on them up to the time the assets are put into use should be considered as part of the cost of the properties. Once the properties are put into use in regular operations, interest thereafter will be recognized periodically as expense.

The weakness in the above treatment is pointed out by Paton and Paton in their statement, "cost of particular physical assets is not affected by the type of financial structure employed in raising the necessary funds." These accountants do not question the validity of capitalizing the interest during the initial period. They simply advocate capitalization as a general cost of getting the business under way rather than inclusion in any specific tangible asset accounts.

It is in accordance with the above reasoning that the recommendation is made in this study that interest costs during the organization period be capitalized as organization

---

19Paton and Paton, op. cit., p. 475.
costs rather than as costs included in specific tangible asset accounts. (The subsequent amortization of the amounts capitalized in this way should be governed by the recommendations stated earlier in this chapter for the amortization of organization costs in general.)

A final criticism of the present accounting for organization costs deals with the balance-sheet classification of the item. As noted earlier, there is no consensus of opinion among accountants as to the section of the statement in which organization costs should be classified. The sections commonly used are the deferred charges section and the intangible assets section.

Earlier in this study (Chapter II) the desirability of the functional basis of classification for assets was discussed in connection with the basic accounting concept of meaningful statement presentation. Under such a basis of classification, an intangible asset section was suggested for those assets arising from expenditures made for the acquisition of rights and privileges which are required for or which will facilitate the normal conduct of the business over a relatively long term. Assets such as patents, copyrights, trademarks, and leaseholds are customarily placed in this section in current accounting practice.

From the standpoint of a going concern, organization costs should also be placed in the intangible asset section of the balance-sheet. Expenditures for organization costs are made for the purpose of securing rights and privileges which are just as necessary for the conduct of the business as those
acquired under a patent or copyright. It is true that these rights and privileges are somewhat more closely identified with the enterprise as a whole than are those arising through items such as patents and copyrights. Organization costs are no doubt in greater jeopardy than most other intangible assets if a liquidation point of view be taken. But the accounting process is not designed from the liquidation point of view. The going concern concept is basic in its structure. There is reasonable basis, therefore, for suggesting that organization costs not be discriminated against because of their lack of realizable value but instead be placed on a par with other intangible assets. The recommendation on this point, therefore, is that organization costs not be classified in a deferred charges section at all but instead be placed in the group of intangible assets of non-current nature which are used in the regular conduct of the business.
CHAPTER VI

DEVELOPMENTAL COSTS

THE NATURE OF DEVELOPMENTAL COSTS

The expenditures discussed in the preceding chapter were those which are incurred rather directly for the purpose of effecting the legal and financial organization of an enterprise. At the time an enterprise is launched, other expenditures, not identifiable with specific tangible acquisitions, and of a more general nature than organization costs, are often necessary. The term "developmental costs" is here used to refer to such expenditures.\(^1\) The nature of such expenditures is indicated in the following examples. Production and sales personnel must be employed and trained by the new enterprise. Administrative procedures and records must be developed. A program of research and experimentation may be necessary in perfecting the product to be produced, after which the production procedures and routines must be developed and perfected. A survey of market conditions is often necessary, and the distribution methods and procedures must be established. Customer contacts must be made and extensive

---

\(^1\) A survey of current accounting literature (see Bibliography) does not reveal any precise definitions distinguishing sharply between organization costs and developmental costs. The distinction between the two terms can best be appreciated by noting examples usually cited for each. The most common of such examples have been repeated in this study as a means of indicating the sense in which each of the terms is customarily used in accounting today.
Expenditures for advertising may be made for the introduction of the new product. Although expenditures such as these do not bring to the enterprise any assets of a tangible nature such as land and buildings, it must be admitted that in many instances they are just as essential for the establishment of the enterprise as are the expenditures for tangible facilities. Without them, the service potential of the tangible facilities might never be made effective.

Expenditures of the type mentioned above are especially heavy during the initial "developmental" period of the enterprise—the period extending from the point of formal organization to the point when it can be said that the enterprise is established as a going concern. In some cases some developmental expenditures actually arise prior to the date of formal organization, and in many cases, expenditures of this nature will be made throughout the lifetime of the enterprise. Many businesses carry on more or less continuous programs of research and experimentation. In other instances, such programs are instituted only when some special problem or need arises. Extraordinary advertising expenditures may be made by an established enterprise for the introduction of a new product or a new model of the old product. New production methods may require the retraining of employees. The addition of new product-lines or departments may require the employment and training of additional employees.

As will be noted in the later discussion, the accounting treatment of expenditures of this type is not uniform, and
the classification of such expenditures for balance-sheet presentation purposes is not standardized. Consideration is
given to these expenditures in this study of deferred charges since many accountants refer to them as deferred charges and
present them in a deferred charge section of the balance-sheet.

The term "developmental expenditures" is sometimes used
to refer to expenditures which can be clearly identified
with certain tangible facilities. For example, the expendi-
tures for the removal of the surface earth for strip-mining
operations and for the construction of roads on such proper-
ties are sometimes referred to as developmental expenditures. In other cases, expenditures which can be clearly identified
with certain intangible assets such as patents and copyrights
are sometimes referred to as developmental expenditures. The
writers who use the term in this way usually do not mean that
the expenditures they are referring to are really to be
classified as deferred charges, entirely separate from the
assets to which they relate. There is fairly general agree-
ment among accountants that such expenditures should be
identified with the assets to which they relate and should not
be capitalized as separate items to be shown in a deferred
charge section of the balance-sheet. For this reason, in the
following discussion, little attention will be given to those
expenditures which are made for the development of specific
assets.

Finney and Miller, op. cit., p. 455.
THE DETAILED ACCOUNTING FOR DEVELOPMENTAL COSTS

Although there is considerable variety in the treatment of developmental costs in accounting today, there does seem to be fairly general agreement among accountants that developmental expenditures are expenditures which will render real benefits and services for the enterprise. In the case of some such expenditures, the stream of services resulting may be quite long, flowing through many years, possibly over the entire lifetime of the enterprise. In other cases, the stream of services may be quite short, running through perhaps only one or two years. In many cases, the precise determination of the exact term of benefit may be difficult, if not impossible.

From an idealistic standpoint, the proper treatment of developmental costs is easy to state. Each expenditure should be capitalized to the extent that it represents a cost committed by the enterprise for future benefits. The cost should then be assigned as expense periodically so that at the end of the beneficiary term the entire expenditure will have been charged against the revenues of the periods receiving benefits and services from the expenditure. However, to put this procedure into practice is not easy in some cases. Over what term of years will the benefits from an employee-training program be realized? How will the turnover of employees and the possible need for retraining affect this? What is the persistency of the pulling-power of an extensive advertising program? How long will the administrative and productive procedures as initially developed remain in use? What about
changes required by changes in product and by expansion? To
what extent are current research and experimental activities
wasted and to what extent are they productive of future
benefits? Because of the difficulty of answering questions
such as these, the current accounting treatment of develop-
mental costs falls short of the ideal.

There are many accountants who take the position that
the best treatment of developmental expenditures is to write
them off immediately. Various arguments are offered in
support of this procedure. It may be argued that this pro-
cedure is easy to follow and results in bookkeeping economy
inasmuch as the items are disposed of immediately and require
no further bookkeeping attention. It may also be argued that
it is easier to maintain a consistent policy by absorbing all
such expenditures when they are incurred than by assigning
some costs to future periods. It may be argued that many of
these expenditures are of recurring nature throughout the life
of the enterprise and that by assigning such to expense when
incurred, essentially the same result will be obtained as if
all were capitalized when incurred and then amortized

3 A typical statement on this point is as follows: "Most
companies follow the practice of treating such costs as ex-
penses of the period in which they are incurred." Ronald H.
Robnett, Thomas M. Hill, and John A. Beckett, Accounting--
A Management Approach (Chicago: Richard D. Irwin, Inc., 1951),
p. 328.

4 The arguments as stated here were taken from an answer
to a question presented to the special section of The Journal
of Accountancy edited by Carman G. Blough. The discussion
was published in The Journal of Accountancy, LXXXIII (1947),
500.
periodically as expense. It may also be argued that this procedure is conservative, that there is no possibility of overstating current income and of recording as an asset an expenditure which in reality will render no future service or benefit. Each of these arguments is subject to weakness, and the combined arguments do not establish a conclusive case for the use of this method.

The fact that it is not possible to do something the ideal way does not justify an immediate jump to the easiest way. A compromise somewhere between the two may really be the better solution. The immediate write-off of each such expenditure does result in maintenance of a consistent policy, but there is little virtue in the policy if it is consistently wrong. The third argument would be considerably stronger if the various developmental expenditures were actually spread evenly over the life of the enterprise. In many cases, however, this will not be true. Such expenditures often fall much heavier in the early years of the enterprise life. Those expenditures that do fall subsequent to the initial period are, to a large extent, of such nature that they will tend to bunch together. The argument of conservatism is subject to the same weakness usually found when this argument is used

5For example, in the case of the introduction of a new product to the established line, expenditures for the perfecting of the product and the production process, for the training of employees engaged in its production, and for the intensive advertising campaign used to help introduce it will all fall at or near the time the product is introduced rather than being incurred evenly over the years during which that product is to be distributed.
in accounting circles. It is true that the current profit will not be overstated, but the profits of future periods may be overstated if this procedure is followed because these periods are being relieved of expense assignments which should really be charged to them. Current profits will not be overstated; they will probably be understated instead and the financial condition reported on the balance-sheet will likewise be understated. For some individuals who seek to use the information, such conservative understatement may be just as misleading and harmful as would possible overstatements of similar amounts.

There are some accountants who follow the immediate write-off procedure as given above, but with one variation. In the event earned surplus and/or current earnings are not sufficient to cover the write-off, the expenditures will be capitalized and carried as deferred charges until earnings will permit writing them off. 6 This practice might be described as "conservatism, with reservations," or as "conservatism, with inconsistency." If the expenditures should be written off for the sake of conservatism, it would seem that there is even greater demand for conservatism when no surplus and earnings exist than when earnings are large enough to stand a charge of this sort. The absence of surplus cannot change the nature

---

6 "It is prudent that such items be charged off within a reasonably short time, as soon as a sufficient surplus is available to absorb the charges." T. Reginald Cloake, "Development Expense An Intangible Asset," The New York Certified Public Accountant, XI (1940-41), 39.
of an expenditure from expense to asset. The adherents of this method probably would not claim that they believe this to be the case, but the implication in the procedure they follow is to this effect.

A third procedure is followed by other accountants. They advocate that all the developmental expenditures which take place during a limited period at the beginning of the life of the enterprise should be capitalized. These amounts will then be left unamortized, to remain as permanent assets of the enterprise. Expenditures arising after this initial period are to be assigned as expense immediately as they are incurred.\(^7\)

This procedure has some of the characteristics of both of those discussed above. It tends to provide for writing off the expenditures when earnings will permit, inasmuch as it delays the immediate write-off procedure until the early, lean years have passed. It does not provide for a deliberate capitalization of an expenditure simply because earnings are not large enough to cover an immediate write-off. It also implies that the enterprise really begins to receive benefits and services from the early developmental expenditures only after the initial period has elapsed. There is also the implication that after the initial period, all developmental expenditures will be incurred evenly over the life of the enterprise.

It is apparent that all three of the procedures discussed above fall short of perfect compliance with the concept of matching costs and revenues. This failure does not seem to

\(^7\)Paton and Paton, op. cit., p. 484.
stem from any lack of recognition of the applicability of the concept in connection with this type of expenditure, but rather from the difficulty of determining with any degree of objectivity just how these expenditures should be assigned to expense. The combination of intangibility and lack of clearly defined life unquestionably do make adherence to the concept more difficult, but there does seem to be reasonable grounds for questioning whether complete abandonment of the concept is justified. The useful lives of some tangible assets are difficult to estimate precisely, yet few accountants would advocate that they be written-off immediately for this reason. Of course it may be stated that the tangible asset probably has a cash realizable value and the developmental expenditures probably do not. But the one who takes this position in defending the discrimination against the developmental expenditures is not only guilty of departing from the concept of matching costs and revenues but has also departed from the going concern concept as well. On a going concern basis the lack of cash realizable value is not, alone, sufficient grounds for excluding an item from the balance-sheet.

In concluding this section dealing with the detailed accounting procedure for developmental expenditures, the following suggestions are offered: Each expenditure of this nature, of material amount, should be considered on its merits and should not automatically be subjected either to immediate capitalization or to immediate assignment as expense. Those expenditures which are related to specific tangible assets,
such as land, buildings, and machinery, or which are related to specific intangible assets, such as patents and copyrights, should be identified therewith. By so doing, a more accurate estimate of the term of benefit from the expenditure can probably be obtained. Inability to so identify any general developmental expenditure should not discredit the expenditure. Those expenditures which are nonrecurring in nature, or which recur only erratically during the life of the enterprise should be capitalized. The life of each should be estimated as well as possible and the cost of each should be assigned as expense on that basis. If it is later discovered that the estimated life being used is wrong, the amortization program should be adjusted accordingly. Those expenditures of regularly recurring nature may be charged as expense when incurred if they recur in such a manner as to result in a fairly even charge to expense from period to period. If their recurrence is at intervals of several accounting periods, and if several tend to recur together rather than in alternate years, they should be capitalized and then amortized to expense systematically. To facilitate the proper consideration and treatment of each expenditure, individual accounts should be used in preference to a single account for all developmental expenditures.

8It seems reasonable to assume that if the estimates are made in a sincere and prudent manner, errors in one direction will tend to be offset by errors in the opposite direction. The effect of this will be to produce results which will be more accurate than will be the case where the errors are all biased in one direction by taking the "conservative" approach.
THE BALANCE-SHEET CLASSIFICATION OF DEVELOPMENTAL EXPENDITURES

The accountants who recommend that developmental expenditures be capitalized do not agree as to the proper section of the balance-sheet in which the capitalized amounts should be presented. There are some who would place them in the intangible asset section; there are others who would place them in a deferred charges section. It is with the latter that exception is here taken.

Those accountants who recommend the deferred charge classification offer little explanation for its use aside from the statement that these are expenditures which will benefit future periods and they should therefore be deferred. In this respect, the developmental expenditures are similar to those made for facilities such as machinery and equipment, but those accountants do not place machinery and equipment costs in the deferred charge section of their balance-sheets. In the same respect, developmental expenditures are similar to those made for items such as patents and copyrights, with the additional similarity that none of them result in the acquisition of any tangible facilities. But those same accountants do not classify patents and copyrights in the deferred charge section. The difference in the classification of developmental expenditures as compared with machinery and equipment may easily be justified on the basis of the tangibility characteristic. But this distinction does not exist when developmental expenditures are compared with items such as patents and copyrights which also reflect rights for future
benefits and privileges of an intangible nature. Can the distinction be based on the fact that patents and copyrights may have some cash realizable value whereas the developmental expenditures may not have any such values, within themselves? To do so is to depart from the going concern concept and there is no more excuse for such departure when dealing with a matter of balance-sheet classification than for departing from it in matters of detailed accounting procedures.

In an earlier chapter, recommendations as to balance-sheet classification sections were presented. It now would appear that developmental expenditures possess all of the characteristics which were there stated as necessary for classification in the intangible asset section. Developmental expenditures give rise to future benefits, not evidenced by tangible acquisitions. The expenditures normally result in a flow of services over several periods; they are therefore of a non-working capital nature. The expenditures are made for regular operating purposes and not as "side-line" investments. It is recommended that the balance of any such expenditure which remains unassigned to expense as of a given balance-sheet date should be classified in the intangible

9See Chapter II.

10Under the procedure which has been suggested for the detailed treatment of developmental expenditures, those expenditures of regular recurring nature and which are for benefits which will expire after a brief term will not be capitalized. Therefore, the amount which will be capitalized under the suggested procedure will not include any normal working-capital expenditures.
asset section of the balance-sheet. Relegation of such expenditures to the deferred charges section, which is usually looked upon with considerable skepticism, is no more justified in the case of these expenditures than in the case of any other expenditures which have been determined to be properly capitalizable. The point has been made before in this study but it may bear repetition at this time, "... neither lack of specific assignability nor legal unavailability for paying debts warrants the conclusion that the costs in question represent balance-sheet items of doubtful propriety."\(^{11}\)

\(^{11}\)Paton and Littleton, op. cit., p. 32.
CHAPTER VII

LOSSES

Three types of losses will be discussed in this chapter. Each type arises from a somewhat different source and the customary accounting treatment of each differs from that of the others. For this reason this chapter is divided into three sections, a separate section being devoted to the discussion of each type of loss.

OPERATING LOSSES DURING THE DEVELOPMENTAL PERIOD

The Nature of Developmental Operating Losses

As has been noted in the preceding chapter, even after the formalities of the legal organization of the enterprise have been completed, the typical business enterprise does not immediately commence operations at what might reasonably be considered to be the normal level of activity for the business. In most instances a developmental period is required during which the momentum of operations is gradually built up, approaching the normal level reasonably expected for the enterprise. The length of this period varies widely for various types of enterprises. In some instances a few months may suffice; in other instances several years of very lean operations may reasonably be expected.¹ During

¹Guthmann and Dougall state that this initial period is most prolonged for two types of business: "(1) those that require a large capital investment which must have an initial
this period, regular operations are started in the sense that sales and deliveries are made to customers and revenue is realized therefrom. However, it is quite common to find that these operations result in net losses rather than net profits, even for the enterprise which is destined to be quite profitable when fully established. These losses are not necessarily the result of inefficiency or poor judgment on the part of management, nor are they necessarily the result of unfavorable general economic conditions existing at the time (although they may be intensified by either of these factors). They are, instead, the normal outcome of operating the business at sub-normal capacity during the developmental period and they are, in many instances, quite unavoidable in getting the enterprise launched as a normal, going concern.

The Accounting Treatment of Losses of this Type

There is a difference of opinion in accounting circles today as to how these operating losses arising during the developmental period should be treated. Many accountants maintain that they should be recognized as losses immediately, even though by so doing a deficit is created. Other accountants
ants maintain that such losses should be capitalized. Some of the latter suggest that they be capitalized under the title of goodwill. Others suggest that they be capitalized as special developmental costs and classified as deferred charges. Those who maintain that they should be capitalized as deferred charges usually suggest that they be amortized as soon as operating revenues are sufficiently large to cover the charge. In such a case, therefore, the amortization program would be based more on the size of profits in subsequent years than any other factor.

The above viewpoints fail to recognize properly the true nature of these losses. Those who maintain that they should be written off immediately are in reality denying that these losses are necessary in getting the business established. Actually, such losses constitute just as much a part of the cost of establishing the enterprise as a going concern as do those expenditures for such tangible facilities as land, buildings, and machinery. The enterprise can no

3 "Many new businesses require several years to become firmly established. Net operating losses in these first few years have frequently been capitalized as goodwill on the theory that operating expenses in excess of income were in reality development expenditures essential to the establishment of a steady patronage and the good name of the concern." Montgomery, Lenhart, and Jennings, op. cit., p. 203.

4 "From the financial point of view, all of these expenditures or losses are necessary outlays drawn from the investors' funds in order to start the business and are thought of as so much intangible investment.... Such costs are necessarily incurred by any business to bring the investment up to the point where a normal going concern exists." Guthmann and Dougall, op. cit., p. 189.
more attain a position of normal operations without passing through the developmental period, long or short, than it can attain such a position without the tangible facilities which it uses physically in its operations. Operating losses during the developmental period constitute a part of the cost of moving the enterprise through that period. They are necessarily incurred in getting the enterprise in the position of a going concern. In this sense, these losses may quite properly be compared with the break-in costs on a new machine. Frequently when a business acquires a new machine it is necessary to operate the machine very carefully for a time to get it ready for normal use on the job. During this period adjustments and minor modifications of the machine may be necessary. Many of the product units turned out by the machine during this period may be defective. The revenue from the sale of the units produced during this period will probably be less than the operating costs incurred. There are few, if any, accountants who would maintain that the costs incurred in the break-in process, reduced by the revenue realized from the units produced during that period, should not be capitalized as part of the machinery cost. These costs are necessary in getting the machine in condition to use in normal operations. Developmental losses are quite similar to these break-in costs. It is true that they cannot be identified directly with any tangible property of the

5Other developmental costs have been discussed in the preceding chapter of this study.
enterprise. They relate to the enterprise as a whole, but, as noted before in this study, the lack of specific identification with tangible property does not deny asset recognition for otherwise valid expenditures.

It must be admitted that in some cases developmental losses may include losses which are not normal or necessary in the developmental process. Inefficient management, accidents, and natural catastrophes may result in losses during the developmental period but which cannot reasonably be considered to be normal costs of launching the enterprise. Such losses cannot be deemed to render any benefit or service to the enterprise in future periods. They should therefore be recognized immediately as actual losses and should not be capitalized, even though by so doing a deficit is created. The absence of earnings in early years (or, for that matter, at any time) is no justification for the deferment of such losses. The normal developmental losses are not capitalized on that basis and no losses not reasonably necessary for the establishment of the enterprise as a going concern should be capitalized merely because of a deficiency of earnings and/or surplus.6 It must also be admitted that in some cases it may

6"The view seems to obtain that if no income or surplus is available from which a loss may be deducted it is impossible to recognize the loss, except perhaps as a deferred charge to future operations. This amounts to a denial of the possibility of a shrinkage in capital during the preliminary period. As a matter of fact asset values are just as susceptible to shrinkage while the concern is getting under way as at any later time." Paton and Littleton, op. cit., p. 96.
be quite difficult to distinguish between normal developmental losses and excessive losses. Such difficulty, however, is no justification for arbitrarily denying the validity of all developmental losses. Excessive prices may be paid for land acquired by the enterprise but there are no accountants who would advocate the immediate write-off of all land costs simply because of this possibility.

It must also be admitted that in many cases the embryonic enterprise does not survive the developmental period and therefore can never reap the benefit of the losses incurred in trying to bring it to a point of maturity as a going concern. In such an unfortunate case, will not a large part of the costs incurred by the enterprise in tangible facilities such as roadbeds, special purpose machinery, and the like, have been incurred in vain? Yet there are no accountants who would advocate that the latter costs should be written off when incurred simply because of the possibility of failure.

---

7No simple rule of thumb can be stated for distinguishing between normal developmental losses (developmental costs) and abnormal losses arising from poor judgment and inefficiency of management. Extreme examples of losses of both types may readily be identified; borderline cases require the exercise of judgment and discrimination, in the light of all attendant circumstances. In some cases a comparison of the losses being considered with losses incurred in the development of other businesses of similar type, size, and location may aid in reaching a reasonable conclusion as to the normalcy of the losses. A careful analysis of the individual expense and revenue items given recognition during the developmental period may help to identify items which reflect inefficiency and poor judgment by management. Throughout the analysis, a long-run, going concern point of view should be maintained unless there is no reasonable expectation that a going concern will emerge from the developmental period.
of the enterprise to mature. To do so with developmental costs (including normal developmental losses) constitutes unjustifiable discrimination and inconsistency.

For rate determination purposes in the public utility field there has been general recognition of the validity of considering developmental losses as capital expenditures. There is also the tendency in this field to include the difference between a normal profit for early years and the actual subnormal profit realized during those years. This practice has led some accountants to advocate that both should likewise be capitalized as assets for regular accounting purposes. This should not be done. Although it is true that, from the standpoint of economics, a normal return (interest) to the proprietary equity for the capital contributed is a price-influencing cost, the customary determination of net profit in accounting makes no allowance for such interest.\(^3\) Net profit in accounting is computed without any deduction of an expense representing a normal return to the proprietary equity. A normal return to proprietors is therefore not considered a cost for accounting purposes, and the foregoing of such a return by owners during the developmental period should likewise not be considered a developmental cost to be capitalized in the accounting records.

The following suggestions are offered as to the correct accounting treatment of developmental losses. First, it may

be noted that the term "losses" is unfortunate and misleading. This excess of normal expenses over revenues during the developmental period does not constitute a loss in the usual sense of the word. It is, instead, a developmental cost and it should be identified as such. These costs should be capitalized. Inasmuch as the service life of these costs coincides with the life of the enterprise itself, the amortization program should be based on the life of the enterprise rather than on the existence of earnings and/or surplus sufficient to absorb the amortization charge. If the life of the enterprise is deemed to be unlimited, no amortization is required. For balance-sheet presentation purposes, these costs should be classified in the intangible asset section. They represent expenditures made for intangible benefits relating primarily to the normal operation of the enterprise. Reasonable care should be observed to avoid capitalization of excessive losses not reasonably necessary in the developmental period just as reasonable care should be observed to avoid capitalization of excessive expenditures not reasonably necessary in the acquisition of any facility for the enterprise.

LOSES RESULTING FROM ASSET REPLACEMENTS

The Nature of Replacement Losses

The typical tangible facility used by the business enterprise has a limited useful life. In some cases the useful life is limited because of physical exhaustion resulting from wear and tear in use and/or deterioration from the passage of
time. In other cases the useful life is limited because of inadequacy due to expansion of the enterprise. In still other cases new inventions may make a facility obsolete. Many facilities are subject to all three of these factors but in most cases only one will be found to be really significant in determining the term of usefulness of a specific asset to a given enterprise. The purpose of depreciation accounting is to provide for the proper assignment of the cost of a facility as expense over the term of its useful life. If this is done properly the book value of the asset will be reduced to realizable value by the end of the useful life.

Several estimates are involved in setting up a program of depreciation for such a facility. The useful life and the realizable value at the end of that lifetime must be estimated. The cost of dismantling and disposing of the asset at the end of its useful life must also be estimated. Because of the impossibility of making these estimates with absolute accuracy, it is not unusual to find that the undepreciated cost of an asset of this type at the end of its useful life does not coincide exactly with the net amount realizable from its disposition. In some cases the realizable amount may be more than the book value. In such cases the excess is normally referred to as gain or profit on retirement of the asset. In other cases the amount received at the time of disposition may be less than the book value of the asset. In such cases the deficiency is normally referred to as a loss. For convenience in this study, losses arising
from the retirement of assets which are replaced by other assets serving substantially the same function will be referred to as replacement losses. It is this type of loss which is the subject of the present section of this study. Losses arising from the retirement of assets which are not replaced will be referred to as retirement losses. Discussion of such losses is included in the third section of this chapter. It should be remembered, however, that both of these types of losses deal with losses which are associated with the retirement of an asset.

The Accounting Treatment of Replacement Losses

On the basis of the attitude they take with respect to replacement losses, accountants may be divided into two groups. There are some who maintain that such losses should be recognized immediately and written off at the time of the retirement. There are others who maintain that these losses should be capitalized. Of the latter group, some advocate capitalization as a deferred charge to be written off as expense periodically in later years. Others of this group advocate recording the loss as an addition to the acquisition cost of the asset replacing the one retired. If this is done, the loss will then be assigned as expense periodically in the depreciation charge on the new asset.

Those who advocate capitalization of replacement losses attempt to defend their position with the following reasoning. The replacement will not take place unless management is convinced that the superiority of the new facility is more
than enough to compensate for the loss of utility remaining
in the asset retired. The superiority may be due to greater
productivity, improved quality of product, lower operating
costs, or some combination of these. If the replacement
takes place, subsequent periods will benefit from such superi-
ority. The loss on replacement arises in the process of
obtaining this superior service. It should therefore be
considered as a cost to be charged to the production in those
periods receiving the superior benefits.

In dealing with an asset replacement, it should be
recognized that the retirement of the old asset and the
acquisition of the new one should be viewed as separate and
distinct transactions even though the replacement may take
place simultaneously with the retirement, possibly with the
retired asset being used as a trade-in on the new one.

At the time the first asset was acquired, its cost
measured the effort expended by the enterprise for the ser-
vices to be derived from its use. At the time the asset is
retired, the services and benefits from its use cease. If
there has been a proper matching of costs and revenues during
its term of use, the cost of the asset (except for an amount
equal to its realizable value) will have been assigned as
expense over its lifetime. If the carrying value of the asset
at the retirement date exceeds its realizable value at that
time, that excess indicates the amount by which expense
assignments over the service life of the asset have been
understated. Inasmuch as the benefits derived from the
asset terminate at the time of retirement, there is no justifi-
cation for carrying forward that excess and assigning it as
expense in later periods which receive no service from the
asset. Even though those later periods are benefiting from
very superior service by the new asset which replaced the old
one, to assign part of the cost of the old asset as expense
to those periods would obviously be an improper matching of
effort and accomplishment. The benefits received in the
periods subsequent to replacement of the first asset stem
exclusively from the assets then employed and if there is to
be a proper determination of income in those periods, the
expense assignments should be based on the cost of those
assets.

The alternative to capitalization of replacement losses
is immediate write-off. Those who advocate this treatment
must admit that their treatment still falls short of perfect
matching of costs and revenues. The amount of the loss which
they write off at the time of retirement actually represents
the total of the understatement of expense assignments during
the life of the asset being retired. To this extent the in-
come statements of those years have been incorrect. The
ideal solution would be to recall and cancel all of those
statements and to prepare new ones for each period in the
light of what is known at the time the asset is retired.
Inasmuch as this would be impractical, an alternative is to
recognize the entire amount of the understatement of expense
in prior years at the time the asset is replaced. By so doing,
the mismatching of costs and revenues in prior years is not remedied in a perfect way but at least its effect is recognized and the mismatching is not carried forward into future years.

It is apparent from the foregoing discussion that the customary accounting treatment of replacement losses as deferred charges (or as additions to the cost of the new asset) constitutes a serious violation of the basic accounting concept of matching costs and revenues. The alternative treatment which recognizes these losses immediately (as extraordinary charges, not as current expenses), although not resulting in a perfect matching of costs and revenues, does conform more nearly with the basic concept than does the capitalization treatment. It is therefore to be recommended in preference to showing such losses as deferred charges.

EXTRAORDINARY LOSSES

The Nature of Extraordinary Losses

A business enterprise may occasionally suffer losses of an unusual nature. Substantial damage may be inflicted on the facilities of the enterprise by floods, earthquakes, tornadoes, hail, lightning, and fire. Unexpected losses of material amounts may be suffered as a result of successful damage suits brought against the enterprise because of patent infringement, negligence of employees, or defective merchandise delivered to customers. Labor strikes may result in substantial losses to the enterprise. Freak accidents
such as a crashing airplane may wreck buildings and ruin equipment. A change in fashions or styles may suddenly cause a product of the enterprise to be outdated, necessitating complete abandonment of specialized machinery used in the production of that product. Trusted employees may embezzle funds intrusted to their care and other losses may be suffered as a result of theft by outsiders.

The above are examples of the kind of losses to which attention is given in this section of this study. The principal characteristics of such losses may be stated as follows: they are all of substantial amount, relative to the size of the enterprise affected; they are of a rather unusual nature, not arising as a result of the normal conduct of the business, although they may be indirectly related to the regular operations; they do not occur with any degree of regularity, and the occurrence cannot be predicted with any degree of certainty. In the case of many such losses, adequate protection in the form of insurance or otherwise may not be possible. (In the case of those only partially covered by insurance, the loss is deemed to be the amount by which the proceeds from the insurance fails to cover the total loss.)

For convenience in the remaining discussion in this section, losses of this type will be referred to simply as extraordinary losses.

The Accounting Treatment of Extraordinary Losses

Although few accountants would do so today, in former years many accountants followed the practice of recording
as deferred charges losses such as those mentioned above. The amounts so recognized were then amortized gradually over several periods following that in which the loss occurred. Little justification for this practice was offered except that the losses were unusual in nature and an immediate recognition of the entire amounts as losses would tend to distort the reporting of current operations. Some accountants felt that since the losses were unusual in nature, occurring infrequently, several periods should be made to bear the charge. A striking example of the practice of deferring such losses is cited by Hatfield in the case of the United Railways Investment Company balance-sheet as of December 31, 1906, on which there appeared, among the assets, "Earthquake, Fire, and Strike, $859,983." Such frankness in presenting the item is no doubt better than concealing it in the amount shown for some valid asset item. However, there is no real justification for presenting the item among the assets. Canning has suggested that it may be desirable to show such an unusual loss as a separate item on the balance-sheet but that it should there be shown as a deduction in the proprietary section of the statement rather than as an asset. 9


10"The keeping upon the books and the showing upon the balance sheet for some years of an item like 'Suspense account,' or 'Losses not yet charged to profit and loss,' has often been condemned. The critics see only that the lost asset is gone and that the proprietary interest is reduced. No carrying forward of the loss will avert it or minimize it. But if the item is fully described there is not only no serious objection
Recognizing that such losses do not render service or benefits for future periods, the majority of accountants today advocate the complete write-off of these items at the time they occur. Accountants differ as to the manner in which the write-off should be made. Some accountants advocate that it be shown as a special charge against the surplus of the enterprise; other accountants advocate that it be shown as an extraordinary charge on the income statement. (It is beyond the scope of this study to discuss the merits of these two presentations.) Neither of these groups advocate that any part of the loss be shown on the balance-sheet as an asset, described as a deferred charge or otherwise.

In view of the prevailing practice in accounting today, further consideration of this type of losses may be omitted in this study of deferred charges. The above discussion has been presented only for the sake of completeness, inasmuch as such losses were frequently presented as deferred charges in accounting practice in former years.

To it, but there may be valuable information conveyed by it. Take the case of a young corporation that has amassed a surplus of $250,000 from profitable operations. Assume a loss of $200,000 from a casualty not possible to avert and not coverable by insurance. Publish a balance sheet immediately afterward showing a proprietary interest equal only to the par of the capital stock plus $50,000. The balance sheet is 'true,' but it is far from expressing the 'whole truth,' for the fact that the concern has been, and has a prospect of continuing to be, a profit earner beyond its dividend rate is suppressed. This fact of the past is of much greater significance for the future than is the fact that a casual calamity has been experienced. If instead of showing the suspense item among the assets, it were shown as a deduction from the proprietary account... (illustration omitted) no one can profess himself deceived, and all are more fully informed." John B. Canning, op. cit., p. 29.
CHAPTER VIII

EXPENDITURES FOR EXTENSIVE REMODELING, REARRANGEMENT
AND REINSTALLATION OF EXISTING FACILITIES

THE NATURE OF THESE EXPENDITURES

Remodeling expenditures are expenditures incurred in renovating and/or altering buildings and similar structures. For example, rental property is often remodeled so that it will meet the needs of new tenants. Changes in partitions, windows, doors, and the like may be necessary. A general refurbishing of the property may also be necessary before new tenants will move in or in order to retain old tenants. Aside from rental property, an enterprise may find it desirable to remodel buildings which it is using itself. An increase in office personnel may necessitate the subdivision of office space. A shift from the use of rail transportation to the use of motor truck carriers may necessitate a change in the location of loading docks and platforms. Remodeling expenditures may be made to effect changes in the exterior of a building. In some instances, such expenditures add nothing to the building except a more modern appearance.

Expenses for rearrangement and reinstallation usually relate to property such as machinery, equipment and fixtures. Such expenditures are made for the purpose of changing the location of these items. The change in location may be desirable for various reasons. In some cases it will be found that the original arrangement of such items is not as efficient as
a different arrangement would be. In other cases it may be found that a change in the product being produced may make a rearrangement of the machinery and equipment desirable. The sequence of operations on the new product may dictate a complete relocation of the machines. In still other cases the addition of a new machine may eliminate several old ones and require the rearrangement of the remaining ones.

Remodeling, rearrangement, and reinstallation expenditures range in size from those which are very small and insignificant in amount to those which are of material significance. (In some instances a number of small expenditures, when considered in concert, will constitute a material amount.) In the case of expenditures of immaterial size, expediency and convenience should dictate the treatment to be given to them. In the case of materially significant expenditures, other factors should be considered. The word extensive is used in the title of this chapter to indicate that it is assumed throughout the chapter that the expenditures being considered are of such size as to negate the expediency approach.

THE ACCOUNTING TREATMENT OF SUCH EXPENDITURES

Several questions confront the accountants who are faced with the problem of accounting for expenditures for remodeling, rearranging, and reinstalling existing facilities. Should all such expenditures be charged as expense in the period in which they are incurred or is capitalization proper in some cases?
In the event that capitalization is a possibility, what factors should be considered in determining which expenditures should be capitalized? In those cases where expenditures have been capitalized, what is the proper basis for amortization of the capitalized amounts? Also in such cases, how should the capitalization be recorded in the accounts? All accountants have not arrived at the same answers to these questions. As a result, current accounting treatment of such expenditures is not uniform.

Immediate Write-off or Capitalization

Some accountants today maintain that remodeling and re-arrangement expenditures should be recorded immediately as expenses. For example, Cranston states that it is not unusual to find such expenditures capitalized but that "... better practice, however, is to absorb the expenses in the period in which incurred."¹ The usual argument offered by the accountants who attempt to justify this treatment is that it is conservative.² The tendency to try to be conservative in dealing with expenditures of this type probably arises from the fact that often the expenditures do not result in any increase in the tangible facilities of the enterprise, and the cash realizable value of those facilities

¹Contemporary Accounting, Ch. 7, p. 13.

²"The more conservative practice is to charge such re-arrangement costs to current operations." George Hillis Newlove, C. Aubrey Smith, and John Arch White, Intermediate Accounting (Revised Edition; Boston: D. C. Heath and Company, 1948), p. 118.
that are affected may not be increased at all as a result of
the expenditures. However, as has been noted earlier in this
study, the failure of any expenditure to give rise to such
results is not, in itself, sufficient to require the immediate
assignment of the expenditure as expense. If future periods
derive service from an expenditure, the complete assignment
of the expenditure as expense in the current period results
in improper matching of costs and revenues. It is true that
the income reported for the current period will be less than
would be the case if the expenditure were capitalized, but to
do this is not necessarily conservative, especially if such
treatment results in an overstatement of income reported on
future income statements because of an understatement of the
expense assigned on those statements. On the other hand, if
an expenditure affects only the current period, with no
future periods being benefited, the immediate assignment of
the expenditure as expense is no more than correct accounting
and no question of conservatism is involved in such treatment.
It is true that in the case of some expenditures for remodeling
and rearranging facilities it will be difficult to determine
the term of benefit with absolute accuracy. A similar diffi-
culty is encountered in connection with many expenditures
made more directly for tangible facilities. The existence of
such a difficulty is not justification for a broad policy of
charging all such expenditures immediately to expense.

Many accountants today maintain that certain expenditures
for remodeling and rearrangement should be capitalized.
However, these accountants differ as to the factors which should be considered in deciding about the capitalization of a given expenditure. Some imply that it is the size of the expenditure which is the determining factor; if the expenditure is substantial in amount it should be capitalized. Other accountants, taking a more reasonable approach, base their decision on the effect that such expenditures will have on future operations. For example, Gilman states that an expenditure should be capitalized if it is made with the expectation of increasing the efficiency or earning power of the enterprise. In similar vein, other accountants suggest that an expenditure should be capitalized if it results in increased profits in future periods, the increase being the result of an increase in productivity or a decrease in costs brought about by the expenditure. Kester seems to place primary emphasis on the cost-cutting effects of the expenditure. The essence of these views seems to be that remodeling and rearrangement expenditures are properly capitalizable.

3Contemporary Accounting, Ch. 7, p. 13.
4Gilman, op. cit., p. 485.
5"A basic consideration is to determine whether costs of this kind will result in more efficient operation, lessened costs of production, and hence increased profits. If such appears reasonably achievable, such costs may properly be amortized over a number of accounting periods." Thomas W. Byrnes, K. Lanneau Baker, and C. Aubrey Smith, Auditing (New York: The Ronald Press Company, 1943), p. 350.
6"It should be noted that only material changes of this kind should be capitalized and then only if their effectiveness in cutting costs extends beyond the current period." Kester, Advanced Accounting, p. 22.
if they result in bringing about greater profits in future periods.

A weakness in the above views is that they tend to overlook the fact that some remodeling and rearrangement expenditures are not made with any expectation that future profits will be increased thereby, but are made for the purpose of maintaining the present profit level or for the purpose of preventing a greater decline in profits than would be the case if the expenditures were not made. For example, in mining operations it is often necessary to move equipment to new locations because of the nature of the extractive activities. In such cases, operating costs may not thereby be decreased; the reverse will often be the case because of mining at greater depths. Profits of future periods may steadily decline because of such increased operating costs, but, as a result of the relocation expenditures, they decline less than they would if the relocation expenditures were not made. Clearly in such a case the future periods are receiving benefits from the relocation expenditures, and if a proper matching of costs and revenues is to be maintained these expenditures should be capitalized when incurred and should then be assigned as expense over the future periods receiving those benefits.

In the light of the foregoing discussion, the following recommendations as to the problem of capitalization of rearrangement and remodeling expenditures are offered: Expenditures of this type should be judged on their individual merits. No policy providing for the arbitrary write-off or the
arbitrary capitalization of all expenditures of this type should be followed. Expenditures which are reasonably expected to affect future periods in a favorable way should be capitalized. Benefits may be realized by future periods in several ways: operating costs may be reduced, increases in operating costs may be prevented or curtailed, productivity may be increased, or decreases in productivity (which would otherwise normally occur) may be prevented or curtailed. Expenditures which render no such benefits to future periods should not be capitalized. If they render benefits for the current period alone they should be recognized as expenses of that period. Expenditures which render no such benefits should be recognized immediately as losses. An arbitrary write-off of expenditures without regard to the benefits to be derived from them is not justified, even in an (unsuccessful) attempt to be conservative.

Amortization Basis

Where remodeling and rearrangement expenditures have been capitalized, the question immediately arises as to the subsequent amortization of the amounts capitalized.

Some accountants advocate the use of an arbitrary basis for the amortization of expenditures of this type. Kester, for example, advocates that the cost of rearranging machinery be written off as rapidly as possible.7 To follow such an arbitrary procedure in the treatment of justifiable rearrange-

---

7Ibid., p. 314.
ment expenditures is clearly a violation of the concept of matching costs and revenues and constitutes deliberate manipulation of profits. No justification is offered by the accountants who advocate such procedure, although there is some implication to the effect that a speedy write-off of such expenditures is conservative. (Objections to the practice of conservatism in this manner have been expressed earlier in this study and need not be repeated at this point.)

The proper basis for amortization of remodeling and rearrangement expenditures is closely related to the basis which justifies their capitalization in the first place. The purpose of capitalization is to make possible the assignment of the expenditures as expense in future periods which derive benefits therefrom. The amortization program which provides for the periodic assignment of the capitalized amounts should, therefore, be designed in such a way that the expense will be assigned to those periods which receive the benefits, regardless of how large or how small the profits of the periods may be.

It must be admitted that in many instances the precise determination of the term of benefits arising from some expenditures of this type will be difficult. Several factors may need to be considered. In many cases, the life of the tangible facility in connection with which the expenditure was made will be the governing factor in determining the term of benefit arising from the expenditure. For example, the cost of rearranging and reinstalling machinery should be amortized over the life of the machinery if it is believed
that the machinery will continue in use in that arrangement for the remainder of its useful life to the enterprise. In many cases the term of benefit from a remodeling or rearrangement expenditure may be much less than the life of the tangible facility involved. For example, mining machinery may have to be relocated several times during the course of its useful life. In such cases, the relocation expenditures should be amortized on the basis of the expected term expiring between relocations. Likewise, remodeling expenditures on rental property are often of a special nature to satisfy the demands of a particular tenant and should therefore be amortized over the expected term of occupancy by that tenant. Expenditures for general modernization and "face-lifting" of buildings may have to be repeated several times during the lifetime of the buildings.

Although it is often difficult to determine the exact number of periods receiving benefits from remodeling and rearrangement expenditures and to amortize the expenditures on that basis, the difficulty does not warrant complete abandonment of the attempt and the substitution of an arbitrary method of amortization. An amortization program designed to assign the expense on the basis of the estimated term of usefulness, even though the estimate lacks the precision which might be desired, will normally result in a more accurate matching of costs and revenues than will one which assigns the expense on some arbitrary basis.

Recording the capitalization: In dealing with rearrange-
ment and remodeling expenditures which should be capitalized, accountants today do not agree completely as to the manner in which the expenditures should be entered in the accounting records. Some leading writers in the field maintain that such expenditures should be recorded as deferred charges, or, if the term of benefit is relatively short, as prepaid expenses. Other accountants maintain that such expenditures should be identified clearly with the tangible facility to which they relate. They should therefore be capitalized in the property account itself or in a special account which will be associated with the property account. By so doing, it is possible to report clearly the costs which relate to the various facilities currently in use.

The accountants who advocate capitalization of remodeling and rearranging expenditures as deferred charges offer a strange explanation for their aversion to capitalization in the specific property account. Finney, for example, states

---

8Holmes and Meier state that such expenditures should be charged to expense when incurred or should be set up as deferred charges to operations. Holmes and Meier, op. cit., p. 527.

Newlove, Smith and White suggest that these expenditures should be recorded in special accounts as prepaid expenses which are then to be written off rapidly. Newlove, Smith and White, op. cit., p. 117.

Finney, in speaking of reinstallation costs, states: "The best procedure, therefore, seems to be to carry forward the expense as a deferred charge to be written off over future periods which will be benefited by the installation." H. A. Finney, Principles of Accounting-Introductory (Third Edition; New York: Prentice-Hall, Inc., 1948), p. 389.

9Paton and Paton, op. cit., p. 205.
that "... the reinstallation expense cannot properly be charged to the property account, because that account has already been debited with one installation charge."^10

It is quite correct to maintain that both installation costs should not be reflected in the property account concurrently, inasmuch as only one is ordinarily effective in rendering current benefit. It is quite incorrect, however, to maintain, as implied in the above quotation, that dual capitalization is any less objectionable if the second installation expenditure is capitalized in a deferred charge account. To set up an expenditure in a deferred charge account is no less capitalization than is a direct debit to a property account.

The problem of dual capitalization of costs such as installation expenditures will never be a problem if all such expenditures are given proper treatment. Under ideal conditions, the amortization of preceding expenditures will be completed by the time succeeding expenditures become necessary. For example, assume that mining equipment has just been purchased and installed. The installation costs, $600, is recorded as part of the equipment cost. Assume further that this equipment will have to be relocated every three years in order to keep it near the area of active work.

---

^10Finney, op. cit., p. 389.
Holmes and Meier also state the capitalization of reinstallation costs in the property account would be incorrect because the original cost of installation has already been capitalized in that manner. Holmes and Meier, op. cit., p. 527.
In this case it is clear that the initial installation cost of $600 should be amortized as expense over the first three years, even though the remaining portion of the equipment cost is being depreciated over a much longer term. If such treatment is given to the $600 item, at the end of the first three years no part of it will remain on the books.\(^1\) The cost of reinstallation can then be recorded without fear of dual capitalization of installation costs. The reinstallation cost should then be amortized over its estimated useful life (three years, in this case), and this procedure would be repeated with each relocation of the equipment.\(^2\)

It must be admitted that difficulties may be encountered in some cases in applying the procedure described above. Often it may be difficult to foretell precisely the term of benefit of a given remodeling or rearrangement expenditure.

---

\(^1\)If the periodic amortization of the $600 has been included in the amount recorded as depreciation on the equipment and if this periodic depreciation has been credited to a valuation account such as Reserve for Depreciation-Equipment, the $600 will of course still be reflected in the property account and will be exactly offset by the $600 credit in the valuation account. At the time the machine is relocated an entry, debiting the valuation account and crediting the property account for $600, should be made to remove the effects of the old installation cost completely from both accounts. In the above example it is assumed that no part of the initial installation work facilitates any subsequent reinstallation.

\(^2\)It might be noted at this point that if the cost of dismantling or removing the equipment from a given installation base is of material amount, provision should be made for this in the periodic depreciation charge on the equipment. In this way, each term of three years should be charged with the cost of installing the equipment at the beginning of the term and the cost of dismounting it at the end of the term so that it can then be relocated.
This difficulty does not justify the adoption of an alternative procedure which does not result in a proper matching of costs and revenues. In some cases it will be found that the entire amount of an initial expenditure has not been amortized at the time a succeeding expenditure is made. The unamortized portion of the old expenditure may be compared with the undepreciated balance of an asset which is being replaced.

(The treatment of such balances was discussed in the preceding chapter of this study and need not be repeated at this point.)

In recording expenditures for remodeling, installation, reinstallaution, and rearranging facilities it will often be wise to record the expenditures in special accounts, appropriately captioned, especially in the case of those expenditures which are not expected to yield benefits for a term as long as the property item to which they relate. The use of such separate accounts will facilitate the proper amortization of the expenditures and their complete removal at the time they become superseded by similar expenditures. These separate accounts should not be reported in a deferred charge section on the balance-sheet. Instead, they should be added to the amount shown for the specific facilities to which they relate so that a proper statement of the cost of the facilities currently in use will be presented.
CHAPTER IX

BOND DISCOUNT AND CALL PREMIUM

Discount on outstanding bonds payable and unamortized discount and call premium relating to bonds which have been refunded are commonly treated as deferred charges in current accounting practice. The first of these items is discussed in the first section of this chapter. The latter two, because of their relationship to each other, are discussed together in the second section of the chapter.

UNAMORTIZED DISCOUNT ON OUTSTANDING BONDS

The Nature of Unamortized Discount on Outstanding Bonds

Discount on bonds payable arises whenever the maturity amount of bonds issued exceeds the amount received from the purchasers. The amount by which the maturity amount exceeds the proceeds is the initial discount. For example, if only $88,530.08 is received upon the issuance of $100,000 (maturity amount) of bonds, the initial discount on the issuance is $11,439.92.

Discount on bonds arises as a result of a difference between the market interest rate prevailing at the time of issuance and the nominal interest rate stated in the bond contract. If the market rate is greater than the nominal rate, the bonds will be issued at a discount. The discount will result in an effective interest rate corresponding to the prevailing market rate at the time of issuance. In the
example given above it was assumed that the prevailing interest rate was 6% and the bonds being issued were 20-year, 5% bonds (interest payable annually). The issuance of these bonds for $88,530.08 will result in a yield of 6% to the investor and likewise an effective interest expense of 6% to the issuer.

Most accountants today advocate the periodic amortization of bond discount. Such an amortization program calls for the assignment of a part of the discount as expense each period. The amount assigned as expense is often included in the amount reported as interest expense. By unamortized discount is meant that part of the initial discount which, as of a given time, has not been assigned as expense.

The Accounting Treatment of Discount on Outstanding Bonds

There is a difference of opinion among accountants today as to the proper treatment to be given to bond discount. A few accountants advocate writing it off immediately. The majority of accountants, however, recommend that it be set up in an appropriately captioned account and then amortized as expense periodically over the life of the bond issue.

One of the arguments advanced by those accountants who maintain that bond discount should be written off at the time it is incurred has been expressed by MacNeal as follows:

"Bond discount, on the other hand, does not represent a legal claim for anything, nor does it represent material wealth. It represents merely a present sacrifice of cash for the expected benefit of future gain, much as would the cost of goodwill. If an issuer defaults in the payment of interest, his bonds may be declared immediately payable at their face amounts,
and no attention will be paid to the discounts at which they may originally have been sold. If the issuer retires his bonds before maturity, he must pay their face amounts plus the premium specified in the trust deed, regardless of whether the bonds were originally sold at a discount. At every step in the life of a bond issue, bond discount will be ignored. After its creation it will cease to exist, both legally and practically. It is not a material good, nor does it represent a legal claim on anybody for either goods or services. It cannot, therefore, be considered to be a balance sheet asset.¹

MacNeal's conclusion as to the proper treatment is that it should be closed into capital surplus.² In line with this treatment of the discount, MacNeal advocates that the liability for bonds payable be shown at the face amount and that interest expense be reported at the nominal rather than the effective amount.

The essence of the above argument is that bond discount is not an asset and that it should therefore be treated as a capital loss and written off to capital surplus. Several weaknesses may be noted in this reasoning. As will be noted later in this chapter, it is quite true that bond discount is not an asset. However, the reasons which MacNeal gives are not, in themselves, sufficient to justify such a decision. As has been observed earlier in this study, the fact that an

¹MacNeal, op. cit., p. 282.

²Staub suggests a somewhat similar treatment. "If a different treatment of unamortized discount be desired than the current practice of including it under the assets heading, an argument might possibly be made for showing it as an unallocated deduction from the aggregate capital and surplus because of its unrealizable nature, but certainly not as a deduction from an honest-to-goodness liability." Walter A. Staub, "The Cost Principle," The Accounting Review, XVII (1942), 9.
item does not represent a material good or a legal claim on anybody is not, alone, sufficient to deny asset status for such an item. To maintain so is to adopt a liquidation attitude rather than a going concern approach. In addition, it may be noted that MacNeal's emphasis on what would happen if the bond issue does not run its normal course likewise indicates a departure from the going concern attitude.

Many accountants today maintain that bond discount should not be written off immediately but that it should be set up in an appropriately titled account at the time the bonds are issued and should then be amortized systematically over the life of the bonds. As a result of this amortization program, the initial discount will be amortized completely by the time the bonds mature. The amount of the discount amortized each period is added to the nominal interest relating to the period in order to arrive at the total to be reported as interest expense each period. If the "scientific" method of amortization is used, the interest expense reported each period will indicate the interest expense on the basis of the effective interest rate. In actual practice, however, many firms use the straight-line method of amortization, in which case the periodic interest expense will be only an approximation of the effective interest.

If the above procedure is followed, a problem arises with respect to the presentation of unamortized discount on statements prepared at any time between the issuance date and the maturity date. Many accountants today advocate the
presentation of this item as an asset in the deferred charge section of the balance-sheet.

The argument frequently advanced in the attempt to show that bond discount is an asset maintains that bond discount is really nothing more than interest paid in advance, or prepaid interest. It may be pointed out that the discount arises because the interest payable during the life of the bonds according to the contract rate is less than that which would be payable if the effective interest rate were applied to the face amount of the bonds. To compensate for this deficiency, the issuing corporation is willing to issue bonds which have face amount in excess of the amount received from the purchasers. Referring to the illustration given earlier in this chapter, $100,000 of bonds were issued in exchange for $88,530.08, the excess of $11,439.92 being issued to compensate the bondholders for their receiving interest during the life of the bonds at a contract rate of 5% rather than at the prevailing market rate of 6%. This $11,439.92, therefore, is really nothing more than an advance payment of interest.

The principal weakness in the above argument is its dependence on the notion of prepaid interest. The fallacy

3To emphasize the "prepayment" aspect of the transaction, the issuance of the bonds might be divided into two parts: purchasers pay in $100,000 for the bonds; the issuing corporation immediately pays $11,439.92 to the bondholders to compensate them for the interest they will not be paid during the term of the bonds because the contract rate is less than the market rate.
in this notion was discussed in Chapter IV of this study. Without repeating that discussion at this point, it is sufficient to point out that in the case of the bond issue mentioned above, $88,530.08 is the amount actually borrowed by the issuing corporation. During the term of the bonds, twenty annual payments of $5,000 each, totaling $100,000 will be paid by the issuing corporation to the bondholders. At maturity date an additional $100,000 will be paid, making a total of $200,000 paid to the bondholders by the issuing corporation. Of the $200,000 paid, $88,530.08 constitutes a repayment of the amount originally borrowed. The remainder, $111,439.92, constitutes the total interest over the twenty year term. Of the latter amount, $100,000 is paid in annual installments of $5,000 each on account of the contract interest rate. The remainder, $11,439.92, which is the amount of the discount on the issuance, is not paid until the maturity date. Therefore, in the words of Paton and Littleton, "Far from being prepaid, the discount is unpaid interest, that portion of the total interest which will not be paid until the date the bond is due."\(^4\)

A second argument is sometimes advanced in an attempt to justify the presentation of bond discount as a deferred charge (asset) item. This argument may be outlined briefly as follows. An expenditure which has been made with the expectation of rendering benefits to future periods is properly

\(^4\)Paton and Littleton, op. cit., p. 39.
shown as an asset. An expenditure may arise through the incurring of a liability as well as through the giving up of an asset such as cash. Discount on the issuance of bonds represents the expenditure made to obtain the privilege of using the lender's money at an interest rate which is less than the prevailing market rate. Discount on bonds is therefore an asset.  

Accountants who advance the above argument must immediately plead guilty to inconsistency in their accounting for liabilities. Applying their argument in the case of the bond issue mentioned earlier in this chapter, it may be said that $11,439.92 is the expenditure required (at date of issuance) for the privilege of borrowing at a nominal rate which is 1% less than the prevailing market rate. In like manner, it may be said that $100,000 (twenty annual interest payments of $5,000 each) is the expenditure required for the privilege of borrowing funds at a 5% rate. If it is argued that the former expenditure should be recognized at the time of issuance, it might also be argued that the latter expenditure be recognized at the same time. To do so, an asset of $100,000, possibly described as Cost of Borrowing Funds at 5%, would be set up at the date of issuance and a liability of similar amount, possibly described as Bond Interest to be Paid over Twenty Years, would also be set up. Yet, those accountants

---

5 The foregoing is a summary of the argument as presented by Victor Z. Brink in "Bond Discount in the Balance-sheet," The Journal of Accountancy, LXXII (1941), 263-4.
who advocate the recognition of the former expenditure at the
time of issuance do not advocate similar recognition of the
latter. Instead, the majority of them would stoutly maintain
that the contract interest should be recognized only on an
accrual basis. This inconsistency arises primarily as a
result of the failure of the above accountants to adhere
carefully to the concept of a measured consideration as the
basis for recording liability items as well as for recording
asset items.

Some accountants today take a more logical view of the
issuance of bonds at a discount than any of those mentioned
above. Unfortunately they are in the minority. These account-
ants maintain that at the time bonds are issued, the effective
amount of the liability, as indicated by the measured consider-
ation involved in the issuance transaction, is the amount
received from the purchasers. The difference between that
amount and the amount payable at maturity under the bond
contract is part of the effective interest which is not covered
by the periodic payment of nominal interest but which is
eventually paid at the maturity date of the bonds. This
amount is deemed to accrue gradually over the term of the
bonds so that at maturity date, just before payment, the
amount of the liability will be shown as the amount initially
borrowed plus the accrued but unpaid effective interest, the
sum of which will correspond to the face amount of the bond

---

6Paton and Littleton, op. cit., p. 38.
issue. (In addition to the foregoing amount, there will also be accrued at the maturity date the contract interest for the final interest period.) At any date between the issuance date and the maturity date, the amount borrowed to date is the amount initially borrowed plus the portion of the discount which has accrued up to that time.

A common objection to the above procedure is that the item for bonds payable in the liability section of the balance-sheet does not show a liability equal to the face amount of the bond issue until the maturity date is reached. It may be argued that a reporting of the liability item at an amount which is less than the face amount of the bonds constitutes an improper understatement of liabilities. It must be admitted that the issuance of bonds at a discount does not ordinarily give the issuing corporation any right, legal or otherwise, to retire those bonds later for less than face amount. It must also be admitted that the presence of unamortized discount on outstanding bonds does not relieve the issuing corporation of liability for the payment of full face amount in the event of liquidation. But, from the standpoint of the going concern (and this standpoint is generally accepted as a basic element in the accounting structure today), the focal point for the consideration of bond retirement is the maturity date rather than any intermediate date. To maintain that the face amount of bonds which were issued at a discount should be shown as the amount of the liability at all times between the issuance date and the maturity date constitutes an
unwarranted adoption of the liquidation attitude in preference to that of the going concern.

The following conclusions with respect to the issuance of bonds at a discount may be stated. Bonds are issued at a discount if the interest rate in the bond contract is less than the market rate prevailing at the time of issuance. The discount on the bonds represents the portion of the effective interest which will not be paid until the maturity date of the bonds. The amount borrowed at the date of issuance is the amount received. The amount borrowed gradually increases over the term of the bonds as a result of the accrual or accumulation of effective interest which is payable at maturity (bond discount). For balance-sheet purposes, the amount of the liability at the date of the statement should be reported as the amount borrowed at that date.\(^7\) If desired, the face amount of the outstanding bonds may be shown parenthetically. Discount on bonds payable is not interest paid in advance, nor does it represent any expenditure from which future benefits may be derived. The classification of bond discount as an asset, deferred charge or otherwise, is not justified.

\(^7\)It might be observed that such treatment is consistent with the accounting procedure customarily followed in the case of bonds held as an investment.
**Refunded Bonds**

A bond issue is said to have been refunded if its retirement has been accomplished through the issuance of new bonds. In some cases the new bonds are issued directly to the old bondholders in exchange for the old bonds. In other cases the new bonds are issued for cash, which is then used to retire the old bonds.

Refunding may take place at the maturity date of the old bonds. If the old bonds can be acquired through open market purchases or through the exercise of a call provision in the bond indenture, refunding may take place at a date prior to the maturity date of the old bonds. The retirement of bonds at a date prior to normal maturity often necessitates the payment of a premium in addition to the face amount of the bonds. (In the remaining discussion in this chapter, premium arising in this way will be referred to simply as call premium.)

In the case of bonds originally issued at a discount, customary accounting procedure today provides for the amortization (or accumulation) of the discount on the basis of the normal life of the bonds. Therefore, in the event such bonds are refunded prior to normal maturity date, a portion of the initial discount will not have been amortized by the time the refunding takes place. (In the remaining discussion in this chapter, this portion of the initial discount will be referred to simply as unamortized discount.)
The following example will serve to illustrate what is meant by each of the above terms and will also serve as an illustration to be used in the later discussion in this chapter. Assume that a 30-year bond issue with face amount of $100,000 and a contract interest rate of 5% was floated in 1930 for $94,000, resulting in an initial discount of $6,000. In 1950, $2,000 of the discount remains unamortized and the carrying value of the bonds is therefore $98,000. At this time, a call provision in the old bonds is exercised and they are retired at 103. The funds required to accomplish this were provided by the issuance of $100,000 of 4%, 20-year bonds at par and by $3,000 taken from the general cash of the corporation.

Several points should be noted in the above case. The old bonds are refunded prior to their maturity date. In the refunding operation, a total of $103,000 was paid to retire the old bonds. The carrying value of the old bonds was $98,000 at the time they were retired. The $5,000 paid in excess of the carrying value reflects two elements; the unamortized discount of $2,000, and the call premium of $3,000.

The Accounting Treatment of Unamortized Bond Discount and Call Premium on Refunded Bonds

The Committee on Accounting Procedure of the American Institute of Accountants has recognized that three different methods for the treatment of unamortized discount and call premium on refunded bonds have advocates among accountants.
Some accountants maintain that the total of these two items should be set up in an appropriately titled account at the time of refunding and that the amount should then be amortized on the basis of the term of the new bond issue. Other accountants maintain that this amount should be amortized on the basis of the remaining life of the bonds retired in the refunding operation. Many accountants in both of these groups identify the item so recognized as a deferred charge. A third group of accountants maintains that the unamortized discount and call premium should not be set up as an asset (deferred charge), but that both items should be written off at the time of retirement, thereby recognizing a loss on the retirement of the old bonds.

The reasoning supporting the amortization of discount and call premium over the term of the new bond issue may be stated as follows: The refunding operation should be considered as resulting in an extension of the original loan agreement. The call premium reflects the cost of obtaining the extension. The call premium should therefore be amortized over the term of the new bond issue. The unamortized discount reflects the unamortized discount on the original loan contract. Inasmuch as the same contract is still in effect, but for an extended term, the unamortized discount should be amortized on the basis of the remaining term of that contract (which is the term of the new bond issue).

The accountants who advocate the above procedure may be described as "fusionists" because they contend that the two bond issues are fused into a single contract. However, it should be recognized that their contention seems to ignore certain things. It is quite true that in some refunding operations the two bond issues have certain common characteristics. In some cases the new bonds are issued to the same investors who held the old bonds. Even in those instances where there is a change in bondholders, it may be admitted that this change is not particularly significant from the standpoint of the issuing corporation. It is also true that, in many instances, the total face amount of outstanding bonds after the refunding operation is the same as the amount outstanding prior to the refunding transaction. But, some of the other characteristics of the two bond issues are not similar. There has been a change in the term of the contract. In many cases, the refunding results in a change in the stated interest rate. These are outstanding characteristics. It does not seem reasonable to contend that two bond issues involved in a refunding operation may be considered as one when the two issues differ in such significant features. It appears to be more reasonable to recognize the two bond issues as being separate and distinct from one another.

The accountants who maintain that unamortized discount and call premium on refunded bonds should be amortized over

---

the remaining life of the old bond issue take an entirely different position from that described above. These accountants point out that the refunding would not take place unless an interest savings could be obtained or maintained thereby. For example, in the case of the refunding operation described above, the annual interest required under the original bond issue was $5,000, whereas the annual interest required under the refunding issue is $4,000. Inasmuch as the original bond issue had ten years yet to run at the time it was refunded, it might be said that those ten years reap the benefit of the refunding operation to the extent of $1,000 per year. It seems quite reasonable, then, to maintain that the unamortized discount and call premium on the old bonds indicate the cost incurred in making possible the realization of these benefits during the ten year period. If this be granted, then, in order to secure a proper matching of costs and revenues, the unamortized discount and call premium should be amortized as expense over the ten years enjoying the interest savings.10

Careful analysis of the above reasoning will reveal that it is quite similar to that which is followed by the accountants who advocate the capitalization of replacement losses on tangible facilities. The weaknesses in that line of reasoning

---

10"It is possible that the advantages of refunding may lie not in a lower cost of money but in an improvement of other conditions attaching to the issues. It nevertheless remains true that the refunding will rest upon comparisons made for the remaining period of the old bonds and that such cases therefore do not change the above conclusions."
have been discussed in Chapter VII. It is sufficient to point out here that in the refunding operation, the unamortized discount and call premium items do not represent any costs of obtaining special benefits to be enjoyed over the remaining life of the old bonds. Instead, they represent the cost of terminating a contract which has now been found to be unfavorable. If adequate knowledge of the future had been available at the time the issuance of the old bonds was being considered, these items would not now present themselves. To carry them forward as deferred charges is nothing less than capitalizing lack of foresight.

A third group of accountants, (among whom may be listed Paton, Littleton, Moonitz and Staehling), recognizing the weaknesses in the positions taken by the two groups discussed above, advocate a more reasonable treatment of unamortized discount and call premium on refunded bonds. These accountants maintain that the two bond issues are entirely separate and distinct, and that the costs relating to one should not be carried forward or fused with the costs relating to the other. If the desirability of retirement prior to normal maturity date is foreseen after the first bonds have been issued, the discount on their issuance plus the call premium which would be required to effect the advance retirement should be combined with the interest indicated by the stated interest rate and the total should be spread as expense assignable to the periods during which the bonds are expected to be outstanding. If such treatment has not been given to
the initial discount and call premium at the time the bonds are refunded, the unamortized part of the initial discount and the entire amount of the call premium should be written off, indicating a loss which must be acknowledged in terminating the bond contract in advance of the originally anticipated date. \(^{11}\)

In summarizing the above discussion it may be stated that there does not appear to be any reasonable basis for carrying forward any part of the unamortized discount and call premium relating to bonds which have been refunded, regardless of whether the period of amortization is the remaining life of the old bonds or the life of the new bonds. It is here recommended that such items be treated in accordance with the third method discussed above—written off entirely at the time the refunding takes place and, therefore, excluded from the deferred charges classification.

\(^{11}\)It might be noted that those accountants who oppose the above view sometimes argue that the refunding would not take place if, by so doing, a loss is incurred. In reply to these accountants, Paton says, "It should be noted that refunding does not cause a loss to be suffered; refunding is rather the occasion for acknowledging the loss which has accrued because the conditions attaching to the original contract are no longer favorable." Paton, Advanced Accounting, p. 643.
CHAPTER X

SUMMARY

A survey of current accounting literature and recent published financial statements reveals widespread use of an asset classification section on the balance-sheet entitled Deferred Charges. The items customarily classified in this section are, to a large extent, dissimilar in nature and are unrelated to one another from the standpoint of the functions they perform for the enterprise. A careful study of the detailed accounting treatment traditionally given to these items reveals numerous instances in which the treatment is inconsistent with generally accepted basic accounting concepts. In the light of such conditions, it is not surprising that the deferred charges section is looked upon with doubt and suspicion by many individuals who examine balance-sheets, and is discounted heavily (often eliminated completely) by many analysts. It may therefore be concluded that the deferred charges section, as presently constituted, serves little or no useful purpose in the balance-sheet.

The objectionable features of the traditional accounting treatment of individual deferred charge items have been pointed out in this study, and recommendations have been made for remedying them. If followed, these recommendations will result in an accounting treatment which is in conformity with basic accounting concepts and will result in a more
useful presentation of these items on the balance-sheet. These recommendations are summarized briefly in this concluding chapter, and the balance-sheet presentation resulting from their adoption is illustrated by means of a model balance-sheet.

PREPAID EXPENSES

The accounting principles customarily followed today in recording expenditures for prepaid expenses are satisfactory. Such expenditures are usually recorded at cost, in conformity with the concept of measured consideration. These cost elements are then held in suspense until they are properly assignable against revenues to which the relate. While they are held in suspense (as assets) they are deemed to be divisible, mobile, and capable of adhering to other cost elements to form new cost aggregates.

The major weakness in current accounting for prepaid expenses is found in the balance-sheet presentation of such items. Traditionally, prepayments have been classified in the deferred charge section of the balance-sheet, far removed from the current assets. This treatment is no doubt largely the result of the liquidating value approach formerly taken by credit grantors. From the standpoint of a going concern, however, prepaid expenses should be recognized as just as much a part of the working capital of the enterprise as cash, accounts receivables, and inventories, even though in some cases prepaid expense items lack both physical
It is therefore recommended that prepaid expense items be classified in the current asset section of the balance-sheet rather than in the deferred charges section. A more accurate statement of working capital and a correspondingly more useful balance-sheet will result.

**ORGANIZATION COSTS AND GENERAL DEVELOPMENTAL COSTS**

The major weakness in the current accounting treatment of organization and developmental costs stems from the fact that many accountants today assume a liquidation viewpoint when considering such costs. Because the expenditures for such items usually do not result in the acquisition of any assets which have cash realizable values upon termination of the enterprise, these accountants are reluctant to recognize such costs as assets. Some accountants advocate the immediate write-off of such costs when incurred. Other accountants are willing to capitalize the expenditures (as deferred charges) but then advocate the amortization of the capitalized amounts as rapidly as earnings and/or surplus will permit.

From a going concern standpoint, organization and developmental expenditures rank on a par with expenditures for tangible facilities. They represent expenditures from which the enterprise will receive services and benefits in future years. In the case of many such expenditures, benefits will be received over the entire lifetime of the enterprise. Any practice which provides for the immediate write-off of such
expenditures, or for an arbitrarily rapid amortization of the costs, causes future periods (which receive benefits from the expenditures) to be relieved of expense charges therefrom, thus resulting in improper matching of costs and revenues.

It is therefore recommended that organization and developmental expenditures be capitalized when incurred. An amortization program should then be established to provide for the equitable assignment of these costs as expenses to the periods receiving benefits therefrom. If the life of the enterprise is deemed to be unlimited, no amortization is necessary for the expenditures which are expected to render benefits over the entire lifetime of the business. Lack of materiality and lack of cash realizable value should not be considered justification for an unreasonably rapid amortization.

It is also recommended that organization and developmental costs be presented in the intangible asset section of the balance-sheet. These items possess characteristics and functions similar to those assets normally classified as intangible assets. They represent expenditures for non-working capital items which do not result in the acquisition of any tangible facility but from which are derived services and benefits which aid in the normal conduct of the enterprise. Intelligent analysis of the balance-sheet will be facilitated if they are grouped with the other assets which possess such characteristics.
LOSSES

Normal losses during the developmental period. The current accounting treatment of normal losses resulting from operations during the developmental period is quite similar to the treatment currently given to organization and developmental costs discussed above. The common practice today is either to write off such losses when incurred or to capitalize them (as deferred charges) and then to amortize them as rapidly as earnings and/or surplus will permit. The same objections which were expressed above in the discussion of organization and developmental costs apply to such losses.

Normal and necessary losses incurred during the developmental period represent costs incurred in getting the enterprise established as a going concern. They are developmental costs. The recommendations stated above in connection with organization and other developmental costs apply with equal force to them. In addition, it is recommended that the use of the term "losses" in connection with such costs be avoided. A more descriptive term such as "excess of costs over revenues during developmental period" would state clearly what the costs represent and would also avoid the erroneous impression that the term "losses" gives when it is used in connection with these items.

Replacement losses. The current accounting treatment of replacement losses is not uniform. Some accountants capitalize such losses, including the amount of the loss as part of the cost of the new asset acquired or setting up the loss in a
separate account identified as a deferred charge. In either case, the amount capitalized is then amortized periodically as expense.

Capitalization and subsequent amortization of replacement losses is incorrect. A replacement loss arises because the cost of the old asset has not been properly assigned as expense during the term of its use. The replacement loss does not render service to the periods subsequent to its recognition, nor does a replacement loss enhance the usefulness of the new asset which does serve those periods. The capitalization and subsequent amortization of replacement losses therefore would result in the assignment of expense to periods which receive no benefits therefrom and would therefore constitute a violation of the concept of matching costs and revenues.

The recommended treatment of replacement losses is to write them off at the time the replacement takes place. Such treatment does not achieve a perfect matching of costs and revenues. To accomplish this it would be necessary to recall the financial statements prepared for preceding years and adjust them to correct the understatement of depreciation on the asset which has been replaced. Such a procedure is impractical in most cases. However, the immediate write-off of a replacement loss does recognize that errors have been made in past periods, makes correction for them in a lump sum, and prevents the carry-forward of such errors into future periods.
EXTENSIVE REARRANGING AND REINSTALLATION COSTS

Expenditures for rearranging and reinstalling existing facilities are treated in various ways by accountants today. Some accountants advocate the immediate write-off of such costs. These accountants usually attempt to defend this procedure by pointing out that expenditures of this type often do not result in any increase in the tangible facilities of the enterprise nor do they cause any increase in the cash realizable value of those existing facilities to which they relate. It is true that these expenditures often do not bring about such results, but this fact alone is not justification for their immediate write-off. If future periods will derive benefits from expenditures, and this is often true in the case of extensive rearranging and reinstallation costs, the expenditures should be capitalized and then amortized as expense over those future periods which benefit therefrom. An immediate write-off of such expenditures not only reflects a liquidation attitude rather than that of a going concern, but also results in an improper matching of costs and revenues.

Many accountants today recognize that many expenditures for rearranging and reinstalling existing facilities should be capitalized. However, there is no uniformity in the manner in which such expenditures are capitalized. Some of these accountants maintain that such expenditures should be capitalized as additions to the cost of the facilities in connection with which they were incurred. This treatment is recommended because it results in a more accurate statement of the cost of
the facilities in their present use.

Other accountants maintain that such expenditures should be capitalized separately, identified as deferred charges. Those accountants who advocate this treatment point out that often the cost shown for facilities already includes initial installation costs and similar expenditures. The addition of reinstallation costs would result in duplication. This is quite true, but the capitalization of reinstallation costs as deferred charges does not seem to be a satisfactory solution to the problem. Duplication still exists, even though in separate accounts, and expenses of future periods will be overstated therefrom. Such duplication, however, can be avoided. If, at the time rearranging and reinstallation costs are incurred, any part of preceding installation and arrangement costs are still included in the cost shown for the facilities, such costs should be written off immediately because their usefulness has expired. New rearranging and installation expenditures may then be capitalized as additions to the cost shown for the facilities to which they relate without danger of duplication.

It is therefore recommended that extensive rearranging and reinstallation costs be capitalized when incurred. The amounts capitalized should be amortized as expense over the periods receiving benefit therefrom. The expenditures should not be identified as deferred charges but should be capitalized as additions to the costs of the facilities to which they relate. In this way, a more accurate and a more useful presentation of the cost of facilities presently in use may be obtained.
Discount on outstanding bonds. Three methods of treating discount on outstanding bonds have advocates among accountants today. There are some accountants who consider discount on bonds to be a loss which should be recognized at the time the bonds are issued. There are others who consider discount on bonds to be an asset (prepaid interest) which should be recognized at the time the bonds are issued and which should then be amortized as expense over the term of the bonds. There are still others who consider discount on bonds to be the unpaid (unsecured) interest not covered by the nominal interest accruals and payments. The conclusion reached in this study is that the treatment advocated by the third group is correct and that the first two groups err because they have an incorrect conception of interest and because they tend to take a liquidation attitude in dealing with liabilities.

The amount received at the time bonds are issued constitutes the amount borrowed through the issuance of the bonds. If more than that amount must be paid to the lenders at maturity of the bonds, the excess is a payment made for the use of the money.\(^1\) The amount so paid does not constitute a loss; services are received therefrom. The amount so paid cannot be considered to be prepaid at the time the bonds are issued; it is not paid until maturity of the bonds. In

\(^1\)In the case of most bond issues, periodic interest payments of stated amount must also be made.
reality, the amount so paid constitutes a payment of a
liability which has arisen because of the accrual of interest
from day to day during the term of the bonds. This interest
should be recognized as expense periodically during the term
of the bonds and a corresponding increase in the liability
relating to the bonds should also be recognized each period.
On a going concern basis, the amount of the liability at any
given time is the amount borrowed plus the portion of such
interest which has accrued up to the given time.

Unamortized discount and call premium on refunded bonds.
There is a difference of opinion among accountants today as
to the proper treatment of the unamortized discount and call
premium relating to a bond issue which has been retired through
the issuance of new bonds. Some accountants maintain that
the unamortized discount and call premium should be shown as
a deferred charge, the amount of which is to be amortized
over what would have been the remaining life of the old bond
issue. Other accountants agree with this treatment except
that they maintain that the amortization should be over the
life of the new bond issue. Still other accountants maintain
that the unamortized discount and call premium should be
written off at the time the old bonds are retired, not to be
carried forward as a deferred charge at all.

The principal argument advanced by those who favor
carrying the unamortized discount and call premium as a
defered charge is that these two items represent costs
incurred in the refunding transaction and that future periods
are benefited by the refunding transaction; therefore these costs should be capitalized and then amortized over those future periods. The conclusion reached in this study is that this argument is unsound. The unamortized discount and call premium do not represent costs which will benefit future periods. Instead, they relate exclusively to the past periods and the old bond issue outstanding during those past periods. They are incurred, not for the purpose of issuing new bonds, but for the purpose of cancelling a contract which has been found to be no longer desirable. They do not render service to future periods; they merely re-establish the status quo. They therefore should not be carried forward as deferred charges but should be written off at the time of retirement of the old bonds.

CONCLUSIONS REGARDING THE USE OF THE TERM DEFERRED CHARGES

In Chapter III of this study, two uses of the term deferred charges were noted. In the case of one, the term is used with a broad meaning, referring to any expenditure which is not to be assigned as expense immediately but which is to be capitalized and assigned as expense in later periods. In this use of the term, assets such as buildings, equipment, merchandise, patents, and copyrights are deferred charges. Most of the assets of an enterprise are deferred charges in this meaning of the term. No objection is offered to the use of the term in this manner. Indeed, greater use of the term in this manner is desirable because it emphasizes the fact that most assets are "expenses held in suspense," a point
which is too often not recognized by many readers of the balance-sheet.

The term deferred charges is also used with a more limited meaning, referring to a relatively few types of expenditures and other items (losses and bond discount), the most common of which have been discussed in Chapters IV through IX of this study. When used in this manner, the term also may serve as a caption for the section of the balance-sheet in which these items are customarily presented. The use of the term deferred charges in this restricted sense is misleading. It indicates that the items so identified are items the amounts of which are to be held in suspense for the moment and later assigned as expense. In indicating this, there is the implication that other items, not so identified, do not possess the same characteristic. However, as noted above, most assets are expenses held in suspense. It is therefore recommended that the term deferred charges no longer be used in the limited sense in which it has customarily been used in accounting.

It should be recognized that the discontinuance of the use of the term deferred charges in the restricted sense should not create any problem of selecting a new caption for the balance-sheet section formerly identified as the deferred charges section. The deferred charges section itself should be discontinued. As pointed out in the foregoing discussion of the individual items customarily identified as deferred charges, more accurate, more analyzable,
and more useful statements will result from the presentation of these items elsewhere. Prepaid expenses should be classified in the current asset section of the balance-sheet, thereby providing a more accurate statement of the working capital assets of the enterprise. Organization and developmental costs should be classified in the intangible asset section with the other expenditures of a non-working capital, intangible nature which are made for the acquisition of rights, privileges, and opportunities which benefit (or are necessary for) the normal operation of the enterprise. Such treatment will provide the analyst with a coherent and complete presentation of assets of this type. Expenditures for extensive rearranging and reinstallation of existing facilities should be capitalized as additions to the cost of the facilities to which they relate and should accordingly be reflected in the presentation of such facilities in the plant asset section of the balance-sheet, thereby providing a more complete statement of the costs relating to the tangible facilities presently in use. The other traditional deferred charge items considered in this study are not assets and should therefore not be presented as such on the balance-sheet, in a deferred charges section or otherwise. Unamortized discount on outstanding bonds payable should be reflected in the presentation of the amount borrowed to date on bonds payable in the liability section of the balance-sheet. Unamortized discount and call premium on refunded bonds, and replacement losses constitute charges relating wholly to
past activities from which future periods derive no benefits. They should therefore not be carried forward as assets but should be charged off immediately when incurred.

It is apparent that the cumulative effect of the above recommendations is the elimination of the deferred charges classification from the balance-sheet. The benefits to be derived from the adoption of these recommendations stem not from the fact that the deferred charges section is eliminated, but rather from the fact that the items formerly presented in the deferred charges section are thereby presented in more accurate and useful fashion elsewhere in the accounting statements.

ILLUSTRATIVE MODEL BALANCE-SHEET

A model balance-sheet, illustrating the recommended presentation of the deferred charge items to which attention has been given in this study, is presented on the following page. This balance-sheet is relatively condensed, suitable for inclusion in the published annual report to stockholders. Information in greater detail may be desirable in balance-sheets to be used for internal administrative purposes. In this illustration, parenthetical comments have been included solely for the purpose of identifying items which have customarily been included in the deferred charges section of the balance-sheet.
MODEL COMPANY
BALANCE-SHEET
December 31, 1952

**ASSETS**

**Current Assets** (or Working Capital Assets)
- Cash
- Temporary Investments
- Receivables
  - Less Estimated Uncollectibles
- Inventories
- Prepaid Expenses (includes short-term prepayments such as prepaid rent, prepaid insurance, prepaid royalties, and prepaid taxes)

**Total Current Assets**

**Long-Term Investments**
- Stock of Y Company - Cost
- Bonds of Z Company - Cost Adjusted for Amortization of Discount To Date

**Total Long-Term Investments**

**Plant**
- Machinery and Equipment - Cost (includes rearranging and reinstallation costs)
  - Less Estimated Depreciation To Date
- Buildings - Cost (includes remodeling costs)
  - Less Estimated Depreciation To Date
- Land - Cost

**Total Plant Assets**

**Intangible Assets**
- Patents and Copyrights - Cost Less Amortization To Date
- Goodwill
- Organization Costs - Cost Less Amortization To Date
- Developmental Costs - Cost Less Amortization To Date

**Total Intangible Assets**

**Total Assets**

**EQUITIES**

**Current Liabilities**
- Accounts and Notes Payable
- Accrued Current Liabilities

**Total Current Liabilities**

**Long-Term Liabilities**
- 2% Debenture Bonds, 1965
  - Amount Due At Maturity
  - Less Unamortized Discount

**Total Liabilities**

**Stockholders' Equity**
- Capital Stock (details stated)
- Earnings Retained in the Business

**Total Stockholders' Equity**

**Total Equities**
SELECTED BIBLIOGRAPHY

A. BOOKS


B. PERIODICAL ARTICLES


Hanson, Arthur W., and Roy B. Kester, "Comments on 'An Introduction to Corporate Accounting Standards,'" The Journal of Accountancy, LXIX (1944), 440-5.


"Reports on 'An Introduction to Corporate Accounting Standards' and 'A Statement of Accounting Principles,'" The Journal of Accountancy, LXI (1941), 48-62.

C. ACCOUNTING RESEARCH BULLETINS
(Issued by the Committee on Accounting Procedure of the American Institute of Accountants.)

Unamortized Discount and Redemption Premium on Refunded Bonds,

Depreciation on Appreciation, Bulletin No. 5. New York:

Report of Committee on Terminology, Bulletin No. 7 (Special).

Report of Committee on Terminology, Bulletin No. 9 (Special).

Unamortized Discount and Redemption Premium on Bonds Refunded,

Accounting for Intangible Assets, Bulletin No. 24. New

James Mathews Owen, son of William Thomas and Myrtle Mathews Owen, was born on the twentieth day of May, 1917, in Ruston, Louisiana.

He attended the public schools in Alexandria, Louisiana, and was graduated from high school there in January, 1934. In September, 1934, he entered Louisiana College, Pineville, Louisiana, and was graduated in May, 1938, with a Bachelor of Arts Degree. After a year of business experience he accepted appointment to a graduate fellowship in the College of Commerce, Louisiana State University, and May, 1942, he received the Master of Business Administration Degree.

After serving as an enlisted man in the Finance Department of the Army of the United States for three and one-half years, he entered the Graduate School of the University of Illinois in the Summer Session, 1946. In September, 1946, he accepted appointment as Instructor in Accounting at Louisiana State University, and enrolled on a part-time basis in the Graduate School of Louisiana State University. In June, 1949, he passed the Uniform Examination for Certified Public Accountants and received a C. P. A. certificate from the State of Louisiana.

He is at present an Assistant Professor of Accounting at Louisiana State University and is a candidate for the degree of Doctor of Philosophy.
EXAMINATION AND THESIS REPORT

Candidate:  JAMES M. OWEN

Major Field:  ACCOUNTING

Title of Thesis:  AN ANALYSIS OF THE TRADITIONAL ACCOUNTING TREATMENT OF DEFERRED CHARGES

Approved:

[Signatures]

Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination:  

[Signature]  APRIL 30, 1953