LIABILITIES

An Examination of Uses of the Word in Accounting and Law with Special Emphasis on Their Suitability for Corporate Financial Statements

DISSERTATION

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By

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CHAPTER I

INTRODUCTION

After many years of neglect accountants are now concerned about the meaning of the word "liability." Most accounting literature has taken it for granted that the word is self-explanatory. For example, the Committee on Terminology of the American Institute of Certified Public Accountants, in defining liabilities, refers to them as "liabilities in the popular sense of debts."¹ Events of the postwar period, however, have focused attention on the meaning of liabilities.

Since the end of World War II leasing has become a popular form of financing the acquisition

¹American Institute of Accountants, Review and Resume, Accounting Terminology Bulletin Number 1. A report by the Committee on Terminology (New York: American Institute of Accountants, 1953), pp. 13-14. The American Institute of Certified Public Accountants is the present name of the American Institute of Accountants. It will be referred to as the Institute in later references.
of plant and equipment. Many firms have used this method to acquire rights to the use of property. Yet the present accounting rules regarding the reporting of assets and liabilities do not permit the leased property rights and the lease obligations to appear on the balance sheet.

The Internal Revenue Code of 1954 permits the accelerated depreciation of plant and equipment for income tax purposes. Many firms have chosen to depreciate their assets in this manner for tax purposes and have continued to use straight-line depreciation for financial reports. As a result, there is the problem of how to deal with the difference between the tax on taxable income and the tax that would have been payable (and will be payable in the future) on the financial income. A controversy over the treatment of this difference still exists, seven years after the introduction of the problem.

The professional journals have been filled with articles suggesting solutions to the problems raised by leases and deferred income taxes. The articles have, however, been limited to a specific
item and have not considered the entire range of items which might appropriately be included in a liability classification.

The meaning of a "liability" was of such great importance to one particular industry that it resulted in a law suit against the Institute. In April, 1959, three utilities obtained an injunction that forbade the Institute's mailing a letter stating that the "Deferred Income Tax Account" should be reported as a liability or deferred credit. Although the suit was dismissed and the injunction dissolved, the controversy over the disposition of the account in the statements continues.²

The letter was prepared by the Committee on Accounting Procedure for the purpose of clarifying Accounting Research Bulletin Number 44 (revised),

²Complete details of the case are available in The AICPA Injunction Case - Re: ARB No. 44 (revised) (Chicago: Arthur Andersen & Co., 1960).
Declining-balance Depreciation. The bulletin called for the recognition, in the accounts, of the difference between the tax payable and the tax that would have been payable on the financial income; this difference to be reported as additional depreciation or as deferred income tax payable. The utilities felt that the account should be included with the owners' equity accounts and not reported as a contra-asset or liability, a position which the Committee felt was not proper.

The injunction was obtained on the grounds that the Committee failed to send the letter through the same exposure process that the original bulletin had gone through, and thus had not given the utilities an opportunity to object to the conclusion stated in the letter. The real purpose, as implied in a report in Business Week of May 2, 1959 (p. 25), was to try

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to prohibit the publication of the Committee's position. By its publication the utilities felt that the conclusion would become a generally accepted accounting procedure and would require the utilities to report the "deferred income tax account" among the liabilities, or as a contra-asset in order to receive unqualified audit opinions and in order to have their statements acceptable to the Securities and Exchange Commission.

The utilities felt that this was going to hurt them when they went to the capital market. The inclusion of the account among the liabilities would reduce the amount of debt-capital that could be issued because of regulatory agencies' restrictions on the amount of long-term debt that utilities can issue. In those cases where debt-capital could be issued, the utilities claimed that the cost of capital would be higher. Also, because of the increased debt, the owners' equity security issues would be less attractive to investors.

Although the complaint was made by utility companies, the effects of the change would be about the same on any company. The cost of capital and the attractiveness of a capital issue is a function of
the risk in a particular situation; the greater the liabilities, the greater the risk.

This case points up the importance of accounting procedures. It also indicates that careful consideration must go into any decision to change the nature of the basic items in the financial statements. The basis for classifying an item as a liability has been the legal character of the item. If it was an obligation enforceable at law, it was considered a liability. Although some companies have included accounts among the liabilities that are not legal obligations, accounting theory has continually made reference to the legal character of a liability.

The letter clarifying Bulletin Number 44 (revised) and the Bulletin itself appear to change the basis for the identification of liabilities. Bulletin Number 44 (revised) states that the matching of expense and revenue requires the recognition of a deferred tax account. It is pointed out in the letter that since the account is necessary to the proper determination of net income, it cannot result in a credit to
The current interest in leases and reserves for deferred income tax is but one part of a more important problem. This study will examine the various concepts of liabilities; the present accounting concept, the change suggested by Bulletin Number 44 (revised), and the legal concept of liability, to see if any of them are suitable for corporate financial reports.

Method of Approach

The accounting system of recording and reporting financial data about a business firm is a highly integrated system. It is based on the proposition that Assets minus Liabilities equal the Equity of the Owners. Because the system is based upon an equation, a change in the nature of one of the items, specifically the liabilities, will have an effect upon one or both of the other parts. Therefore, the first task will be to examine, in some detail, the nature of the assets and the equity of the owners. This will require a discussion of the relationship of the balance sheet
and the income statement as they are the major products of the system. This is done in Chapter II.

"Liability" and its close relation, "debt," are words which have fairly precise legal meanings. Accountants have borrowed the words from the law. Although the words were borrowed, the strict legal meanings were not borrowed. Chapter III considers the legal meanings of the words. Specific attention is paid to the law of contracts, since most business liabilities arise from contracts.

Accounting literature, the releases of the Securities and Exchange Commission, Bulletins of the Committee on Accounting Procedure and the Committee on Terminology of the American Institute of Certified Public Accountants, and the pronouncements of the Committee on Accounting Concepts and Standards of the American Accounting Association are examined to determine the generally accepted concept of liabilities. Reserves, preferred stock, and commitments are compared with the concept in order to indicate how it is to be applied to specific situations.
The alternative meanings of liabilities and their application in accounting practice are considered in Chapter V. A suggested definition is presented and tested against various items, some of which appear on current balance sheets, and others which do not.

Chapter VI summarizes the findings of the study. The suggested definition is restated. A list of accounts which should be included among liabilities and a list of accounts now found among the liabilities, which should not be included on the balance sheet, are presented.

Limitation of the Study

The emphasis in the project has been on characteristics appropriate for the classification of an item as a liability. Therefore, there has been no attempt to suggest the techniques by which the items might be valued for reporting purposes. The determination of an item's basic characteristics must come first. Then attempts must be made to find valuation techniques which will permit the item to be reported.
This position is taken in full recognition of the fact that the item must be measurable in terms of money before it can be of practical value in financial reporting.
CHAPTER II

THE NATURE OF FINANCIAL STATEMENTS

Accounting is the art of accumulating, reporting and interpreting the financial data of an enterprise.¹ This study is concerned with the interpreting and reporting of the data. The financial data are reported in various statement and schedule forms. There are two statements, however, which have passed the test of time, and can be said to be the most important statements. They are the balance sheet and the income statement. They have passed the test of time because they provide their users with the most important information necessary to measure the relative success or failure of an enterprise.

The measure of accomplishment in a free enterprise system is the profitability of an enterprise.

¹Accounting Terminology Bulletin Number 1, p. 9.
Profitability is measured by comparing the profits earned by the enterprise to the capital employed in earning the profit. The income statement provides information about the profits, and the balance sheet provides information about the capital employed by the enterprise.

The statements are prepared from information gathered in a system which is highly integrated. The system, and the reports that are prepared from it, are based on the proposition that Assets minus Liabilities equals the Equity of the Owners. The balance sheet reports, in detail, the kinds of assets, the kinds of liabilities, and the nature of the equity of the owners. The income statement reports the increase (or decrease) in the equity of the owners as a result of operating activity.

The two statements are obviously related. The change in the equity of the owners cannot occur without changes in the assets and liabilities. The changes in the assets and liabilities are caused, in part, by operations. The income, as will be shown
shortly, is measured by changes in the value of assets and liabilities. Therefore, it would seem that the balance sheet is the dominant statement. This is not true, however.

The free enterprise system places emphasis on the making of profits. For this reason the income statement has become the dominant statement. The pressure for proper income measurement has become so great that often the effect on the balance sheet of adjustments made for the purpose of measuring income have been ignored. If not ignored, the adjustment has not been properly reported on the balance sheet. This has resulted in the distortion of the balance sheet. It is strange that this distortion has occurred because the elements which make up the profit are defined in terms of the balance sheet accounts.

The Balance Sheet

The accounts appearing on the balance sheet have often been referred to as the real accounts, and those on the income statement as the nominal
accounts. The reason for this is clear. The balance sheet accounts have generally included things which are valuable to the firm, and therefore to the owners. The balance sheet accounts also include the obligations of the firm—those things which require the things of value for their satisfaction—and the equity of the owners in the things of value. The income statement accounts measure the changes in things of value and obligations, that are caused by the profit-making process. These accounts do not represent things which exist, as do the asset and liability accounts.

**Assets**

The assets are the things of value which a firm owns. What characteristic is it that creates the value? The characteristic is the service that the item can provide in future operations. Cash is valuable

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because it can be used to acquire goods and services necessary for the production of future revenues. Accounts receivable and other claims to cash have value because they will soon be cash. The plant and equipment, the inventories, and the prepaid expenses all have value because they are used in the production of future revenue.

If an item can no longer contribute to future revenues, it is not an asset. This does not mean that a piece of equipment, now considered obsolete, is without value. Its value is measured by the cash which can be collected when the equipment is sold for scrap, rather than by its future services.

Each of the types of assets has an important characteristic in addition to that of future use. The firm has a legal right, which exists at the date of the balance sheet, to receive the future services. The cash and the claims to cash that exist at the balance sheet date can be used to acquire goods and services in the future. The same is true of the other assets; the right to future services exists as of the balance sheet date.
Thus, an asset has two characteristics. The item must be capable of being used to produce future revenues, and the right to the use of the item must exist at the balance sheet date.

There are certain things which seem to have the characteristics of assets, and which are often called assets, that do not appear on balance sheets. Employee skills, management skills and customer good will are but three examples. Although these things have value to the firm, and often play a significant role in the amount of profit earned, they are not assets in the accounting sense. The firm has no present legal right to them in future periods.

There are other items of value, which do not appear on balance sheets, and yet seem to have the required characteristics of assets. Leases are one example. The lessee has the legal right (at the present time) to use the item leased, in the future, assuming he makes the lease payments as called for in the agreement. Certainly, if the leased property will contribute to future revenues and the lessee has the legal right to use it in the future, it has the characteristics of
an asset. Yet leases do not appear on balance sheets. The same analysis can be made of purchase commitments, personal service contracts, and other legal commitments. They do not appear on the balance sheet because assets are defined not only in terms of their characteristics, but also in terms of the way by which they were acquired. The Committee on Terminology of the Institute defines assets in the following manner:

Unexpired costs (assets) are those which are applicable to the production of future revenues.

Cost is the amount, measured in money, of cash expended or other property transferred, capital stock issued, services performed, or a liability incurred, in consideration of goods or services received or to be received.4

The definition of cost is the important one. The cost is to be measured, among other ways, by the "liability incurred."

The rights to the future use of leased property are not received in exchange for any other asset, or

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services performed, or capital stock issued. They are obtained in exchange for a promise to pay cash in the future. If anything, the promise to pay is a liability. Obviously it is not a liability in the accountants' meaning of the word or leases would be reported on the balance sheet.

**Liabilities**

In accounting usage, the word "liabilities" means debts. Debts are a special form of liability arising from an agreement where one of the parties has performed his part of the agreement; and the other, who owes the debt, has not. Thus in the leasing case, the lessor cannot perform his part of the agreement, providing the item being used during the agreed upon periods, until the periods actually pass. Therefore, there is no debt, and for accounting purposes no liability. Chapters III and IV will explore more thoroughly the legal and accounting meanings of liabilities.
Equity of the Owners

The equity of the owners is a residual one. The claims of the creditors (liabilities) are superior by operation of the law. Therefore, the equity of the owners is the assets minus the liabilities. The equity may be accounted for, and usually is, in two types of accounts; the paid-in-capital, and the retained earnings. The significance of the division is in the fact that the retained earnings account or accounts show the increase (or decrease) in the residual equity over the amounts paid in by the owners, as a result of operating activity.

The Income Statement

The purpose of the firm is to increase the equity (net assets) of the owners. Once increased the owners, or more correctly, their representatives, decide whether the increase should be paid out in dividends or used to further increase the equity of the owners by investing it (the increase in net assets) in the operations of the firm. The increase in the equity of the owners--profits, can be measured by
of the period but are charged to the period in question, and therefore are deductible from revenues; and the normal meaning of expense, expired costs which contributed to the creation of the revenues of the period.

In each case the definitions refer to balance sheet accounts. The revenues are "measured by the charges to customers . . ." or, in other words, by the cash or claims to cash received from the customers. The expense and losses are expired costs, and the costs are measured by accounts which appear in the balance sheet.

The Interrelationship of the Statements

Despite the fact that the elements making up the profit are defined in terms of the balance sheet accounts, it is difficult to determine whether the elements of profit are measured by changes in assets and liabilities or the changes in assets and liabilities are measured by the elements of profit. Because of the emphasis on profit measurement the assets and liabilities are sometimes determined by the revenues and expenses.
For example, consider the present treatment of losses from purchase commitments. In order to comply with the accounting procedure that requires losses to be recorded in the accounts when "clearly in prospect," the loss is charged against the revenues of the period in which the market price drops below the commitment price. "The credit offsetting the charge to a loss account is listed among the liabilities . . ."  

The account appearing among the liabilities certainly doesn't have the characteristics of a liability in the usual accounting sense.

The Committee on Accounting Procedure's reasoning on the "deferred income tax account" is inclined in the same direction. The justification for the account being a liability is that the matching of expense and revenue requires the recognition of the charge for taxes based on financial income. This is contrary to the usual case where the cost (expired or unexpired) is determined by the liability.

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The deferred tax account is a liability (see Chapter V), but not for the reasons given by the Committee.

The balance sheet is used to judge the financial position of the firm. An investor is interested in the financial position because it helps him judge the ability of the firm to meet the obligations the firm has already incurred. It also helps the investor to know what resources, that the firm now controls, are available for use in the production of future profits. Reporting accounts as assets or liabilities which do not have the characteristics of assets or liabilities destroys the usefulness of the balance sheet.

The balance sheet reports the things of value owned, the existing obligations which must be satisfied from the things of value owned, and the residual interest--the owners' equity. The income statement reports certain types of changes in the assets and liabilities, and therefore in the owners' equity. The characteristics of assets and liabilities control the recognition of expenses and revenues, and not the reverse. This is not to say that the valuation of
assets and liabilities should not be influenced by the measurement of expense and revenue. The recognition of the wearing out of a machine is a proper expense for the purpose of income measurement, but it does not create a liability. It measures the decline in value (in the future service meaning of the word) of the machine.

Summary

The firm is organized for the purpose of increasing the equity of the owners in things of value. Therefore, the other factors in financial reports should be defined in terms of the things of value. The following definitions, which are basically in agreement with the Institute's Committee on Terminology definitions, are used in the remaining chapters.

Assets - Money and claims to money, and services to be received in the future (from persons or objects) for which a present legal right to the future service has already been acquired.

Expenses - Assets, or something that would have been an asset if it had not been immediately consumed, consumed in the process of producing revenues.

Losses - Assets, or something which would have been an asset had it existed before the loss
occurred, whose value has disappeared without contributing to revenues.

**Revenues** - Assets, or something which would have required assets for its satisfaction, received from customers in exchange for goods and services.

**Liability** - Not defined at this point because the purpose of this study is to define liabilities.

**Owners' Equity** - The residual equity in the assets.
CHAPTER III

THE LEGAL MEANING OF A LIABILITY

Accounting definitions of a liability often refer to the law, or to other words which also have as their basis, the law (Chapter IV). The legal meaning of the word "liability" differs in some respects from the accounting definition. As "liability" is borrowed from the law, and accountants refer to the law when defining "liability," the legal meaning of the word will be examined.

Another word, closely related to "liability" is also used frequently in accounting. The word is "debt." Again, the accounting use of the word does not square completely with its use in the law. Therefore, it too will be examined.

The major source of "liabilities" and "debts" is contracts. All of a firm's business relationships are based upon contractual agreements, except
liabilities for taxes and those arising from law suits. For this reason, some of the elements of contracts will be carefully reviewed.

This chapter has one other purpose. A liability (or debt) relationship, of the firm with others, is usually created by a contract. The ownership interest in a firm is always established by contract. The characteristics which distinguish the two types of contractual agreements will be discussed.

The Meaning of Liability

The exact meaning of the word "liability" in the law is not clear. The courts do not agree on the meaning of the word. For example, consider the following definitions taken from Black's Law Dictionary.¹

An obligation, one is bound [underlining added] in law or justice to perform. (Murphy v. Chicago League Ball Club, 221 Ill. App. 120, 126)

[The] condition of being actually or potentially [underlining added] subject to an obligation. (Enyeart v. City of Lincoln, 285 N.W. 314, 318)

The first one cited indicates that there is no question about the fact that a liability is an obligation which is enforceable by law. The other definition, by the phrase "potentially subject to an obligation," indicates that it may not be enforceable by law. It would not be if the potential obligation does not come into existence.

Black's Law Dictionary, after considering all of the court definitions, describes "liability" as

a broad legal term. . . . It has been referred to as of the most comprehensive significance, including almost every character of hazard or responsibility, absolute, contingent, or likely. 2

The word has been used in many ways, and the above quotation is more of a comprehensive description than a definition of the use of the word.

Most of the definitions imply the existence of some relationship between persons from which an enforceable obligation may arise. That relationship may arise from a contract, a suit for damages, or a

2Ibid.
29

legislative assessment. In any event, the distinguishing feature of "liability" is that it includes obligations which might be enforceable by law. A clearer understanding of the meaning of the word "liability" may be gained by comparing it to the meaning of "debt."

The Meaning of Debt

"Debt," in contrast to "liability," has a very specific meaning in law. Debt "is a common-law word of technical meaning; . . . ," the technical meaning being "a sum of money due by certain and express agreement; . . . ." It is used to describe the obligation of the party to a contract who has not performed to the party who has performed.

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4 26 CJS 2.
It [a debt] arises at the very moment that the obligation is undertaken and continues until discharged by payment. Therefore, in this broad and comprehensive sense, if any time elapses between the performance of the service on the one hand, and the payment of the money or thing of value... on the other, the relation of the parties to each other will be that of debtor and creditor, and the thing which is owed by one to the other will be a debt.\(^5\)

The above excerpt is complete except for the fact that it doesn't make it clear that the obligation is payable "without regard to any future contingency."

It has been said that the basic idea of "debt" as a legal term, is that an obligation has arisen out of a contract express or implied, which entitles the creditor unconditionally to receive from the debtor a sum of money, which the debtor is under legal, equitable, or moral duty to pay without regard to any future contingency [underlining added]; ... 6

Every debt ... must be certainly, and in all events, payable; whenever it is uncertain whether anything will ever be demandable by virtue of the contract, it cannot be called a "debt." ... While a sum of money may be payable upon a contingency, ... it becomes a debt only when the contingency has happened, ... 7

\(^{5}\)26 CJS 4.  \(^{6}\)26 CJS 3.  \(^{7}\)26 CJS 5.
Although "debt" is usually associated with contracts, it has frequently been used to describe obligations other than those arising out of contract.

Although the word "debt" is usually limited to liabilities arising out of contract, . . . and not such obligations as are imposed upon him by law in his [a person] public relations, or in common with all other citizens, yet it need not be confined to obligations for the payment of money arising on contract; . . . so the term has been construed to include all kinds of obligations, . . .

The Distinction Between "Liability" and "Debt"

The courts are not always precise in their use of terms. This leads to less precise meanings for words than is desirable. The words, "debt" and "liability," have been used interchangeably on occasion. Is there then, a difference between "liability" and "debt"? Generally, the law recognizes a difference.

A liability is an obligation arising from an existing relationship which will, upon the happening

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826 CJS 3.
of certain events, become enforceable by law. If the event does not occur, then the obligation no longer exists. A debt is an obligation which is due without regard to any future happening. Therefore, a liability becomes a debt if and when the contingent event occurs.

The Characteristics of Obligations

The obligations classified as "liabilities" or "debts" must be enforceable at law. To be enforceable in law they must have certain characteristics. Obligations can arise from three sources; legislative assessment, judicial assessment, and contracts.

The characteristics of legislative and judicial assessments which make an enforceable claim are obvious. The legislature and the courts are the makers and interpreters of the law. If the legislature passes an act taxing certain property or activities, any person whose property or activities falls within the purview of the act is obligated to pay the tax. The obligation is enforceable because it is imposed
by the law. (This assumes that the act is constitutional.) The courts, when interpreting the law in damage suits, assess the party or parties in accordance with the law. Here again, the obligation is enforceable in law because it arises from the law.

Obligations arising from contracts do not arise from the law itself. The obligations arising from contracts are enforceable only when certain elements are present: only when (1) there are parties competent to contract; (2) there is valid subject matter; (3) there is legal consideration; (4) there is mutuality of agreement; and (5) there is form as required by law, is there an enforceable contract.\(^9\)

Once it has been established that a legal contract exists, the law imposes a duty upon the parties to perform in accordance with the agreement. If one of the parties fails to perform his part of the

agreement, then the courts will see that the other party receives damages.\textsuperscript{10}

The Law of Contracts

There are three aspects of the law of contracts which need further review. They are consideration, acceptance (which indicates mutuality of agreement), and order of performance. The first two are important because they indicate the manner by which a contract comes into existence. Order of performance arises only after a contract has been made. It is important because it makes it possible to determine which party has the obligation to perform first.

Legal Consideration

Legal consideration is defined in terms of legal benefits and detriments. Legal benefits are legal rights received by the promisor (the one who makes the promise to pay) to which he was not previously entitled.\textsuperscript{11}

\textsuperscript{10}\textit{Ibid.}, 14.

\textsuperscript{11}\textit{Ibid.}, 204.
Legal detriments are the promisee (the one who received the promise of money payment) "doing anything legal which he is not bound to do, or refraining from doing anything which he has the right to do." ¹²

Legal consideration takes two forms. It may be the act performed in exchange for a promise to pay money or some other thing of value, or it may be a promise to perform an act (or to refrain from doing a certain thing) given in exchange for a promise to pay money or some other thing of value. A contract with an act as consideration is called a unilateral contract, the other form of consideration makes the contract bilateral.¹³

Thus, a firm may become obligated under contract by two different forms of consideration. If the firm requests an act in exchange for its promise to pay something of value, and the act is performed, the firm has an obligation. An example of a contract of this type is a purchase order that does not call

¹²Ibid.
¹³Ibid., 15.
for an acknowledgment of intention to perform by the vendor. If the firm requests a promise to perform an act at some future time, and the offeree communicates acceptance, a contract is made and the firm has a liability. A purchase commitment is an example of this kind of contract. (The foregoing statements are true, if all the other elements essential to make a contract are present.)

Acceptance

In order for a contract to be made there must be an acceptance of the offer by the offeree. The general rule is that the acceptance must be communicated to the offeror (the one making the offer).¹⁴ If the acceptance is not communicated, there can be no contract.

There are two exceptions to the general rule. The performance of the act (or the forebearance from doing an act) called for in a unilateral contract need not be communicated to the offeror unless he is

not in a position to know that it happened. In such a case, communication to the offeror, within a reasonable time, that the act has been performed is necessary.\textsuperscript{15} A purchase order which does not request acknowledgment would be an example of a contract not calling for communication of the acceptance. The shipping of the merchandise would constitute acceptance of the contract. The receipt of the goods by the purchaser would remove the need for communication of the fact, that the act was performed, to the purchaser.

The other exception relates to the acceptance by silence. The rules governing the acceptance by silence are so strict that they are not, in general, applicable to the business relationships of a firm.\textsuperscript{16}

**Order of Performance**

The order of performance by the parties to a contract is a problem only in bilateral contracts.

\textsuperscript{15}\textit{Ibid.}, 68-69.

\textsuperscript{16}\textit{Dykstra & Dykstra}, pp. 143-4.
In unilateral contracts the act is done; then the promisor is called on to perform.

The order of performance is the order called for in the contract. If the contract calls for delivery of merchandise, with payment to be made 30 days after delivery, then the delivery must come before the obligation for the payment is enforceable.

Not all contracts specify the order of performance. In those cases the common law has established certain rules of order. For example, if the two promises are capable of being performed simultaneously, such as a promise to deliver merchandise and a promise to pay for it, and no statement as to order is found in the contract, then they must be performed at the same time. The rules themselves are not important to this study. What is important is that the law establishes which party is obligated to perform first. The obligation is not a debt, for a debt may arise out of contracts only after one party has performed.

17 For specific detail on order of performance see Grismore, pp. 194-205.
The Relationship of "Liability" and "Debt" to the Law of Contracts

The existence of a contract does not mean that any of the parties to it have a debt. If the contract is an executory contract, a contract in which neither party has performed, each of the parties to the contract has a liability, but neither has a debt. This is true because each has an obligation which may be enforceable by law.

It would seem appropriate to say that the party obligated to perform first has a debt because the obligation is enforceable by law. Yet, the author could find no precedent in law for the use of the word "debt" in describing the obligations of the parties arising from an executory contract where neither party has performed.

If the contract is executory as to one party, then a debt arises from the contract. The party who has performed has a claim against the party who has not performed. That claim, if it is not contingent on the happening of some event, is called a "debt."
A "debt" and a "liability" can exist as a result of one contract. In a lease agreement the rent due for rental periods already gone by is a debt. The obligation for the future rent payments is a liability.

The Difference Between an Owner and a Creditor

The creditor of a firm receives his equity in the assets of the firm from a contract. The owner of a firm also receives his interest in the assets of the firm from a contract. How are the two distinguished?

The distinction between the two types of equities in the firm is easily made in most cases. The difference between the two classes of equities is stated well in the following excerpt from a case.

Those are not creditors, who cannot withdraw from the venture without the consent of the rest, demanding a fixed sum at some period set in advance. [underlining added]18

The creditor can, and does demand, and receive his

18Jewel Tea Co., Inc. v. U.S. 90 F2d 451, 453 (1937). See also, Jordan Co. v. Allen 85 F Supp 437 (1949); In re Fechheimer Fishel Co. 212 F 357 (1914).
investment at some fixed date. The owner cannot demand the return of his investment.

There are some cases, however, where the distinction is not too clear. The problems in this area are centered around bonds and preferred stocks. Certain bonds seem to have the characteristics of preferred stocks and certain preferred stocks seem to have the characteristics of bonds.

The necessity for determining whether a security is a bond or a preferred stock arises most frequently in tax cases. The deductibility of interest and the non-deductibility of dividends make the determination important.

The aspects of the relationship between the firm and the holders of the security in question to be examined are (1) the fixed date of maturity, (2) the relationship to other creditors, (3) the name of the certificates and the treatment of the securities by the parties, (4) the source of the payments—must there be income or surplus before the payments are made, (5) the right to participate in management,
and (6) the right to sue in the case of default. Each element has been the controlling factor in at least one case.

The existence of or absence of a maturity date usually is the fact on which the case turns.

The fact that he ultimately must be paid a definite sum at a fixed time marks his relationship to the corporation as that of a creditor rather than a shareholder.

However, in some cases where the security had a maturity date, the court decided that other factors outweighed the fixed date of maturity. The most prominent other factor was that the new security, identified as an interest paying obligation, was issued in exchange for previously outstanding common stock.

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20 Commissioner of Internal Revenue v. O.P.P. Holding Corporation 76 F2d 11, 12 (1935).

21 See, for example, Crawford Drug Stores v. U.S. 220 F2d 293 (1955) and Talbot Mills v. Commissioner of Internal Revenue 3 T.C. 95 (1944) upheld in John Kelley Co. v. Commissioner of Internal Revenue 326 U.S. 521 (1946).
Although the courts did not specifically state that the intent of the parties in those cases was to avoid taxes, rather than create a creditor-debtor relationship, they implied it.

Despite the fact that some courts have held that a fixed maturity date does not necessarily establish the existence of the debtor-creditor relationship, the prevailing legal view is that the difference between an owner and a creditor is the creditor's right to demand, at some predetermined date, the return of his investment in the firm.
CHAPTER IV

THE ACCOUNTING MEANING OF A LIABILITY

It has been traditional in American accounting literature to recognize that the owner should be separated from the business—the concept often described as the "separate entity principle." The outgrowth of this attitude is the recognition that there are two types of claims against the business. The first is the creditors' claim, the other being the owners' claim.

The claims are, however, of a different nature. The creditors' claims are for the return of principal and often a sum representing a charge for the use of the principal.

The owners' claims are not for the return of principal. The owners commit their funds in the hope of earning a return on those funds, without any expectation that they will receive the principal back. An
individual contributor to the enterprise might invest in a firm with the expectation of recovering his principal, as well as earning a profit on his investment. He will be able to recover the principal only by selling his interest to another party, or by dissolving the enterprise. The firm, however, has no obligation to return the principal.

The existence of the position that the right side of the balance sheet represents claims against the enterprise may in part be responsible for some of the confusion surrounding the term "liabilities," because the owners' interests are not claims in the same sense as creditors' claims. Another contributing factor appears to be the failure to use a term borrowed from another profession, the law, in its usual (legal) meaning.
Liabilities in Accounting Literature

The term "liabilities" seems to have (or have had) three meanings in accounting, namely:

1. All credit balances appearing (properly) upon the right-hand side of the balance sheet.
2. All credit balances found upon the right-hand side of the balance sheet except the balances representing the owners' equity.
3. The legal debts of the firm.

All Credit Balances Appearing (Properly) on the Right-Hand Side of the Balance Sheet

The Committee on Terminology of the American Institute of Certified Public Accountants currently defines liabilities:

Something represented by a credit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting, provided such credit balance is not in effect a negative balance applicable to an asset.¹

This is not the definition accepted in practice or theory, as will be seen later in the study. Furthermore it is not a particularly new definition.

¹Accounting Terminology Bulletin Number 1, pp. 13-14.
Cole, in discussing the characteristics of a balance sheet, presents an illustrative statement in which the right-hand side of the balance sheet is labeled "Liabilities." Included in this balance sheet category in the example were Capital Stock, Bills Payable, Accounts Payable, Reserve, and Profit and Loss.²

This position follows his classification of accounts as "internal and external." "External accounts are those kept with persons, partnerships, associations, corporations, and the like."³ The external accounts include both assets and liabilities and the proprietor relationship to the firm:

The business has relations with its proprietors, of course; but those proprietors are not the business, and for the purposes of accounting they are treated just as any outsider is treated . . . .⁴

Cole's exposition on accounting does not make it entirely clear whether or not "Surplus," i.e.,

³Ibid., 21.
⁴Ibid.
unreserved retained earnings, is a liability.\(^5\) In keeping with the "entity theory" of the firm he considers the surplus account as a "nominal" account and therefore not a liability.

Profit and Loss as shown here, [on page 86 of his book] is a pure nominal account, measuring the excess of resources over specific recognized liabilities. . . .

It [the profit and loss account] may appear under any one or more of several other names,--Loss and Gain, Surplus, Undivided Profits.\(^6\)

But in apparent contradiction to this statement he labels the right-hand side of his balance sheet, which includes the Profit and Loss account, "Liabilities."

An unusual account included among the liabilities by Cole is the reserve for bad debts. The allowance for bad debts "(. . . will appear as a liability, of course,) . . ."\(^7\) Why he does this is not

\(^5\)Cole, on page 89, suggests that reserves such as those for contingencies, insurance, retirements, and replacement of fixed assets are properly shown among liabilities even though they are deducted from net income.

\(^6\)Ibid., 95.

\(^7\)Ibid., 108.
explained in the chapter. This treatment is not in keeping with his general analysis of asset valuation, for decline in value of fixed assets due to "actual depreciation" is recognized by Cole as a decrease in the asset. ⁸

The Institute and Cole generally agree that the items normally found on the right-hand side of the balance sheet are "liabilities." They differ in the following respects. Cole includes the "reserve for bad debts" accounts, which the Institute would recognize as a negative asset account. With specific reference to owners' equity category, both the Institute and Cole would consider the owners' investment as a liability. They disagree on retained earnings, however. Cole, as pointed out earlier, considers this

⁸Ibid., 79-84.
a nominal account, while the Institute would include this in its liabilities classification.

. . . investment by the proprietor . . . must appear among the liabilities.\(^9\)

. . . capital stock and related or similar elements of proprietorship are balance-sheet liabilities . . .\(^{10}\)

All Credit Balances Appearing on Right-Hand Side of Balance Sheet—Except Owners' Equity

Most of the current accounting textbooks classify the right-hand side of the balance sheet into a liabilities section and a stockholders' equity section. The distinction between liabilities and stockholders' equity made by the textbooks is based upon the relationship of the various parties to the firm. For example:

Liabilities, that is, creditor equities the amounts of which are fixed by contract between the firm and the claimants; . . .\(^{11}\)

\(^{9}\)Ibid., 28.

\(^{10}\)Accounting Terminology Bulletin Number 1, p. 14.

Liabilities are debts; they are amounts owed to creditors.\(^\text{12}\)

A liability ordinarily represents an obligation of definite amount payable to a specified person or persons.\(^\text{13}\)

Note that each of the definitions is similar to the legal definition of a debt, or refers to the word "debt." However, in the application later in the books, the examples do not always fit the definitions.

Finney and Miller classify liabilities into money obligations, those satisfied by the payment of money; and performance obligations, those satisfied by the performance of service or delivering goods.\(^\text{14}\)

The performance obligations arise in cases where revenue is collected in advance, or in cases where expenses relating to this period's revenue may be incurred in the future. Examples of the first case would be magazine subscriptions and bus tokens. Examples of

\(^{12}\)Finney and Miller, *Introductory*, p. 5.


\(^{14}\)Finney and Miller, *Introductory*, p. 309.
the second case would be product guarantees, and repair service agreements.

If we refer back to the specific legal definition of debt, the first case, that of revenue received in advance, fits the definition exactly. If one party has performed (the buyer in this case), then there is no uncertainty as to the necessity for the seller to perform. The obligation of the seller to perform is not contingent upon the happening of future events.\(^{15}\)

The performance of services such as those required by product guarantee contracts or repair service contracts is contingent. The seller is required to perform only if repairs are needed, or if the product does not meet the standards set in the guarantee. Therefore, they cannot be considered debts in the legal sense of the word.

Paton and Dixon interpret their definition more broadly than many writers. By their use of the

\(^{15}\) The assumption implicit here is that the contract to supply the buyer is not contingent upon some event which may or may not occur. Such contracts are not normal business contracts.
word "ordinarily" [see page 51 of this chapter] expansion of the definition is possible, and this they do.

Under certain circumstances, however, accurate determination of the amount may be difficult or even impossible at a given moment, and the identities of the parties to whom the business is indebted may not be ascertainable until later.16

Thus they support the possibility that items need not be debts in the legal sense in order to be reported on the position statement. They go so far as to suggest that it may be appropriate to recognize a liability "even though there may be some uncertainty . . . as to the actual existence of the obligation."17

Here, however, they create some confusion. They state that a "simple agreement to purchase merchandise at some future date does not in itself create an actual debt,"18 and therefore is not reported in the statement. Yet, they are willing to recognize an obligation whose existence is uncertain.

17 Ibid., 26.
18 Ibid.
There is no uncertainty about the obligation arising from an agreement to purchase merchandise. It must be assumed, in keeping with the general accounting meaning of reportable obligations, that they mean obligations arising from activities where someone has, or may have, already done something for the firm.

Hill and Gordon violate their definition of liability when they give, as an example, the "Estimated Contract Guarantee Obligations" account.\(^{19}\) This account represents the amount expected to be expended in the honoring of the contractual agreement. It is, however, uncertain as to whether any claim will be made under the guarantee agreement, thus removing it from the strict legal sense of debt. A creditor (the word they use in defining liabilities) is one to whom a debt is owed. (See page 27 in Chapter III)

\(^{19}\)Hill and Gordon, p. 149.
The Legal Debts of the Firm

The current position of the American Accounting Association seems to support the division of the right-hand side of the balance sheets into legal debts and owners' equity. The current revision (1957) of Accounting and Reporting Standards of the American Accounting Association describes the distinction in the following manner:

The interests or equities of creditors (liabilities) are claims against the entity arising from past activities or events which, in the usual case, require for their satisfaction the expenditure of corporate resources. The interest or equities of stockholders represent residual claims to corporate assets. . . .

It further states that:

The discharge of a liability at a determinable date is normally required by contract or intent of parties. Such a requirement is not a characteristic of stockholders' equities.

Statements quoted are not unlike the legal definition


21 Ibid.
of debt, and the legal distinction between ownership and creditorship.

The American Accounting Association is not the originator of this highly restricted interpretation of liabilities. The British Joint Stock Companies Act of 1856 described the liabilities section of the balance quite carefully. The liabilities section was to be classified in the following manner:

<table>
<thead>
<tr>
<th>II DEBTS AND LIABILITIES of the Company</th>
<th>Showing:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. The Amount of Loans on Mortgage or Debenture Bonds</td>
<td></td>
</tr>
<tr>
<td>3. The Amount of Debts owing by the Company, distinguishing--</td>
<td></td>
</tr>
<tr>
<td>(a) Debts for which Acceptances have been given.</td>
<td></td>
</tr>
<tr>
<td>(b) Debts to Tradesmen for Supplies of Stock in Trade or other Articles</td>
<td></td>
</tr>
<tr>
<td>(c) Debts for Law Expenses</td>
<td></td>
</tr>
<tr>
<td>(d) Debts for Interest on Debentures or other Loans</td>
<td></td>
</tr>
<tr>
<td>(e) Unclaimed Dividends</td>
<td></td>
</tr>
<tr>
<td>(f) Debts not enumerated above.</td>
<td></td>
</tr>
</tbody>
</table>

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Notice that each of the classifications refers to debts of a specific nature.

Despite the rather strong attachment to the legal meaning of "debt" by the American Accounting Association, it too has deviated from the narrow path of the legal meaning of debt. In *Accounting and Reporting Standards* the American Accounting Association indicates that the issuance of product guarantees and similar events establishes the existence of a liability.\(^{23}\) Product guarantees are liabilities, not debts, as it is not certain that a claim will be made on a particular contract.

**Summary**

The authors and Committee reports cited represent a sample of what has been written on "liabilities." The arbitrary division of the various positions suggested earlier obviously is more apparent than real. It serves only to demonstrate the initial emphasis of the various accounting definitions.

\(^{23}\) *Accounting and Reporting Standards*, p. 6.
First, the semantics of the problem must be solved. This is so future discussion will not be confused by misinterpretation of words. It would appear that "liabilities" has two meanings in present accounting literature: The Committee on Terminology definition, a credit balance properly carried forward (except contra assets); and the more common classification of all credit balances on the balance sheet except owners' equity items and contra asset accounts.

The distinction is not too important for the Institute attaches an entirely different meaning to the word.

For example, capital stock and related or similar elements of proprietorship are balance-sheet liabilities [underlining added] in that they represent balances to be accounted for, though these are not liabilities in the ordinary sense of debts owed to legal creditors.\(^{24}\)

Thus, the Institute is using the term "liabilities" in a very narrow and technical sense. The usefulness of this meaning is open to question since it has the tendency to confuse rather than clarify.

\(^{24}\)Accounting Terminology Bulletin Number 1, p. 14.
The Institute can probably be included with the current view that the right-side of the balance sheet may be classified into two categories, for it says that there is no inconsistency between its definition and the view that the aggregate of liabilities as suggested by the Institute "be referred to as the aggregate of liabilities and capital, . . ."\textsuperscript{25}

Specific Application of the Concepts

There remains, then, the question of what should be included in the liabilities classification on the balance sheet. Current literature would include debts and quasi-debts among the liabilities.

**Legal Debts and Quasi-debts**

Legal debts would be those claims against the firm which are enforceable at law. Therefore, at the date of the balance sheet, they would represent contracts on which the outside party had fully performed; and the outsider's claim, arising from the contract, was certain to be presented.

\textsuperscript{25}Ibid.
The type of items which are discussed in accounting literature falling in this category are accounts payable, notes and other forms of money payables, wages payable, and subscriptions received in advance. Each of the items arises from a transaction in which the other party to the agreement has performed his service. The only item remaining before payment is to be made, is the passage of time. The passage of time would not be considered uncertain.

Quasi-debts arise in the same way as debts, but there is some uncertainty as to whether or not the outsiders' claims will ever be presented. (If presented, however, the claim must be enforceable by law.) The "reserve for product warranties" and "estimated liability on repair service" are accounts which fit this category of liabilities. They are not legal debts because there is no certainty that the seller will be called on to perform under the terms of the contract.

The accountant views the firm as a whole, and in doing so is concerned with the certainty of the claims arising from the entire series of contracts,
and not from each contract taken by itself. Therefore taking the entire series of contracts he is able to say that there is certainty that claims will be made, thus for accounting purposes a "debt" can be said to exist.

Another form of liability may also be described as a quasi-debt. The liabilities for interest and rent which accrue until the date they are to be paid, are not debts in the strict legal sense. Although they arise from a contract and they are certain of becoming an enforceable obligation, they are not debts, until the date of payment. The reason is that the performing party has not completed his part of the bargain. The rent or interest is not due until a specified date, the use of the property or money for the entire period between the payment dates is required before the rent or interest obligation can be called a debt.

**Reserves**

Conspicuous by their absence are the "liabilities" arising from inter-period adjustments for income determination, better known as "reserves."
The items which have been described as quasi-debts are very similar to the "inter-period adjustments"; with one exception, the quasi-debts are created by contractual arrangement, the inter-period adjustments are not. Finney and Miller describe the accounts arising from inter-period adjustments as Operating Reserves.

Operating reserves are those which are set up by charges to income to reflect provisions for prospective cash disbursements, the costs of which should be matched against revenues that have been taken into income.26

However, when enumerating examples of "operating reserves" they mention only those costs which are associated with contractual agreements. Product warranties, repair service agreements, and back-filling agreements (in leased strip mining operation) are the examples given. They arise from contractual agreements and are for this study classified as "quasi-debts."

The 1954 Internal Revenue Code contained provisions allowing the recognition of expenses in advance

26 Finney and Miller, Intermediate, p. 436.
of their future occurrence if they were considered to be associated with the revenues of a period preceding actual occurrence. Although the provision was ill-fated it did create thinking upon the problem of estimated expenses.

From this thinking came several examples of estimated expenses which would fit the inter-period adjustment category. Collection expenses of installment contracts on which profits have been deferred is one example. Provisions for major repairs done regularly at intervals greater than one year; costs of handling, packing, shipping and installing of merchandise already sold; and "reserve for self-insurance" of injury and damage claims are other examples. The credits resulting from these expense estimates would appear as "liabilities."\(^{27}\)

The "reserves" have been classified into three groups; valuation, estimated liability, and retained earnings appropriations. One is warned in accounting that improper classification is not desirable. However, the distinction between types of "reserves" is difficult. Currently there is some confusion in accounting circles as to what to do about federal income taxes postponed to some future date as a result of the use of the "accelerated" methods of depreciation. The Institute and the Securities and Exchange Commission offer no help on the subject.

The Securities and Exchange Commission is of the view that in the earlier years the charge equivalent to the tax reduction should be treated either (1) as a provision for future taxes in the income statement with a corresponding credit in the balance sheet to a non-equity caption such as a deferred tax credit, or (2) as additional depreciation in the income statement with a corresponding addition to the accumulated provision for depreciation.  

The Institute takes the same position in Accounting Research Bulletin 44 (revised).

... it is alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets ... 29

The distinction between retained earnings "appropriations" and "estimated liabilities" is also difficult. It is generally stated by theorists that the "reserve for self-insurance of fire losses" belongs as a segregation of retained earnings. 30 The conclusion is based upon the grounds that this is an "appropriation to 'provide' for anticipated ... losses ..." 31 and therefore not chargeable against income. If it is a charge not necessary to the determination of current income then it cannot have the status of a liability or as a contra-asset. There are no clear

29Accounting Research Bulletin Number 44 (revised), p. 2A.


31Accounting and Reporting Standards, p. 21.
pronouncements by the Institute or the American Accounting Association, however, on this particular account. Terminology Bulletin Number 1 (pages 27 and 28) does use reserve for self-insurance as an example of a "reserve" which should appear as an estimated liability, but does not specify which kind of risk is being self-insured.

Commitments

One of the currently debated issues in accounting is the presentation of leases in the balance sheet. Many writers have called for the recognizing of leases as an asset and, of course, a liability. The major emphasis has been upon "financing leases." "Financing leases" are those in which the lease is a device to acquire the use of property over its economic life.32

The support for reporting long-term leases of this character rests upon one basic point. There is similarity between the commitments made in the typical "financing lease" and those in an outright purchase

accompanied by bond financing. In each case the enterprise commits itself to pay for the asset over the life of the asset (or the life of the bonds). The only difference is that the title passes immediately in the outright purchase; and at the end of the term, if at all, of the lease.

The main arguments against the proposition seem to be two. First, it is difficult to value the lease (a problem not considered in this study), and second, it belongs to a class of contracts, those that are executory as to both parties to the contract, which do not find their way to the financial statements.\textsuperscript{33}

Current and past accounting literature supports this second objection.

A liability is a service, valuable in money, which a proprietor is under an existing legal (or equitable) duty to render to a second person (or set-of persons) and which is not unconditionally an agreed set-off to its full amount against specific services of equal or greater money value due from this second person to the proprietor.\textsuperscript{34} (Italics Canning's.)


For example, the simple agreement to purchase merchandise at some future date does not in itself create an actual debt; ...\textsuperscript{35}

As a result of this attitude, a contract where neither party has performed, although creating "liabilities" (not "debts") in a legal sense for each party, is not reported on the balance sheet. Leases, salary contracts, purchase commitments, and advertising contracts are examples of this type of contract.

Other

The obligations arising from pension plans have received attention in recent years. Specifically the accounting profession has been concerned about the treatment of past-service cost obligations. The pensions are based on an employee's years-in-service, among other things. At the date the plan is adopted the firm ordinarily incurs an obligation to make contributions based on the past service of the covered employees, as well as contributions for current services.

\textsuperscript{35}Paton and Dixon, p. 27.
There have been various suggestions for the recognition of the past-service obligation in the accounts and statements. The recognition of the total amount of the past-service cost as a liability at the date of the plan's adoption, the recognition of a liability to the extent that the unpaid past-service costs have vested in the employee, and the decision to recognize the liability (for past-service costs) as the services are performed in the future since the costs relate to the future services, represent the liability aspect of the suggestions advanced.

The Committee on Accounting Procedure recommends the first alternative. The Committee is willing, at the present, to accept the second alternative as the minimum requirement.36

Preferred Stock

Although there are differences between the rights of the common and preferred stockholders, they have one feature in common. They have made a permanent investment in the firm. This feature distinguishes an owner from a creditor. There are now, however, preferred stock contracts which call for the redemption of the stock at specified dates. This provision gives the preferred stock the appearance of an income bond.

The legal status of the redeemable preferred stock is not clear. If it is a creditor security it can be redeemed at the due date without regard to the amount of retained earnings. If it is considered as evidence of ownership then there must be sufficient retained earnings to permit the acquisition of "treasury shares." Because of this uncertainty, Dewing concludes that the

Obligatory redemption of the preferred stock should be regarded as an expressed intent on the part of the corporation, rather than as an obligation.37

Despite this uncertainty, there is support in accounting for presentation of the preferred stock investment as something other than owners' equity. Paton and Dixon suggest that it be placed between the liabilities and the stockholders' equity because it is more closely related to bonds than to common stock.\(^{38}\) (Paton and Dixon do not restrict this treatment solely to redeemable preferred stock.)

*Accounting and Reporting Standards* recommends that "equities should be reported . . . in a manner which emphasizes their dominant characteristics."\(^{39}\) This statement follows discussion of the fact that payment at a determinable date is a characteristic of liabilities and not of stockholders' equities. There is a clear implication here, it would seem, that a redeemable preferred stock should be reported as a creditor equity rather than as an owner equity.

\(^{38}\)Paton and Dixon, p. 376.

\(^{39}\)Accounting and Reporting Standards, p. 7.
Summary

The credit balance accounts arising from inter-period adjustments of revenue and expense, unless made necessary by contractual agreements (such as guarantees), are not liabilities. The obligations arising from executory (as to both parties) contracts do not fit the current accounting theory meaning of "liabilities."

The current meaning of liabilities, as the word is used in accounting theory, was succinctly stated by Sprague in 1908. Liabilities "considered as uncompleted contracts, . . . are those in which our part of the contract is the part unfulfilled."40

40 Charles E. Sprague, The Philosophy of Accounts (New York: By the Author, 1908), p. 43.
CHAPTER V

A DEFINITION OF LIABILITIES FOR
USE IN ACCOUNTING REPORTS

Comparison of the Legal and Accounting Meaning
of Debts and Liabilities

"Debt" and "liability" are words which accountants have borrowed from the law, but accountants do not use the words as they are used in the law.

A liability in the eyes of the law is an obligation which may be enforceable by law. The obligation will become enforceable if the event specified in the situation underlying the obligation occurs. If the event does not occur then there is no longer an obligation; therefore, there is no liability.

In law a debt arises from an agreement between the parties to a contract where one of the parties has substantially performed his part of the contract. The party, to the contract, who has not yet performed has a debt which runs to the party who has performed. The
obligation will be described as a debt only if it is certain that performance by the one who owes the debt will occur. An obligation to pay taxes or damages is also a debt.

In accounting a liability is recognized, in the accounts and statements, when the other party to an agreement has substantially performed his part of the contract. Taxes and damages would also be considered liabilities. Accountants use the word "debts" interchangeably with "liabilities" when describing the kinds of things which should be reported in the financial statements.

The words "debts" and "liabilities" are used differently in accounting than they are in the law. The law attaches a broader meaning to liabilities than does accounting, and accounting attaches a broader meaning to debts than does the law.

The legal meaning of the word "liability" would require accountants to report, on the financial statements any existing or potential obligations. This would necessitate the reporting, as liabilities,
of a company's commitments of a contractual nature where neither the company nor the other party has yet performed, and the potential obligation arising from law suits in which the company is a defendant, as well as the obligations that are currently reported.

This broader use of the word is not supported in accounting theory, nor is it applied in accounting practice. Commitments arising from executory contracts, and contingent liabilities are not reported in the balance sheet. They may be referred to in footnotes, if they are material in amount, but they do not affect the balance sheet directly.

In accounting practice an item similar to a contingent liability can sometimes be found among the non-owners' equity accounts. Some companies include a "reserve for contingencies" among the non-owners' equity reserves. It is not exactly comparable to a contingent liability as the reserve is seldom related to a specific potential liability. This practice is not condoned in accounting theory, and is not too widespread in practice. (Only 39 out of 600 companies
reported a "reserve for contingencies" outside the owners' equity classification in the 1960 Institute survey.)¹

Accountants do not recognize contingent liabilities in the accounts until the assessment of the claim against the business is fairly certain.² Thus damage suits, tax renegotiations, and the agreement to repurchase sold receivables would not be recorded unless the certainty that the assessment would be made is high. The controlling factor then in recognizing contingent liabilities is the certainty that the firm will be obligated.³

The law is not concerned with the degree of certainty (or uncertainty) of a potential obligation


²Finney and Miller, Introductory, pp. 325-6.

when refering to liabilities. Any potential obligation is a liability even if there is a considerable amount of uncertainty that it will ever become enforceable.

Commitments arising from executory contracts cannot be found in the balance sheet. Purchase commitments, leases, and salary contracts are relegated to footnote status, if they are material, otherwise they are ignored.

The historical basis for failing to recognize commitments as liabilities is not clear. It is clear, however, that they are not reported. Canning would not record them because the unexecuted promises are agreed upon set-offs; Paton and Dixon, because they are not debts (see Chapter IV, page 68). Few writers other than the two cited have bothered to express themselves on this point. It would appear that under modern reporting theory and practice they are not reported because they don't fit the current accounting definition (as written and applied) of liabilities.
Proposed Change in the Accounting Definition of Liabilities

It is proposed here that the definition of liabilities for accounting reporting purposes be changed. Instead of waiting for the other party to perform his part of the contract before recording and reporting any liability, it is recommended that a liability be recognized as of the date the contract is made. Specifically, the definition of "liabilities" to be used for corporate financial reports should be the following definition:

A liability is any commitment or obligation which has a legal basis, and is reasonably certain to be honored. The legal basis may arise from a contract, a legislative assessment, or a court decision.

The definition has two parts to it. First, there must be a legal basis to the obligation; and second, there should be reasonable certainty that it must be met.  

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4See Maurice Moonitz, "The Changing Concept of Liabilities" The Journal of Accountancy CIX (May, 1960), 41-46, for a list of characteristics which are similar to this definition.
This definition would require the reporting, as liabilities, of the commitments arising from executory contracts. It would require taxes, and judgments payable, to be recognized as liabilities (a practice now followed). With special reference to judgments, it is not appropriate to wait until the judgment is assessed to report it in the financial statements. If the certainty of assessment is very high it should be reported from the date there was considerable certainty of being assessed. The definition would not permit the use of the liabilities classification for reporting the balance sheet effects of inter-period adjustments to income which do not have a legal basis.

In order to test its suitability for use in financial statements certain obligations, which fit this definition, but are currently omitted from the statements will be analyzed in terms of the effect their reporting in the statements will have on the statements. Debts and quasi-debts, which are already recognized in the statements, and would be by the proposed definition are not discussed as the definition merely broadens the
definition accepted in accounting theory, and generally followed in accounting practice.

The credit balances arising from the "non-legal basis" inter-period adjustments are also discussed. The purpose is to show that there are more appropriate methods of reporting them, if they are justified, than reporting them as liabilities.

There is a possibility that there is no need for the legal basis. Perhaps all that is needed is the certainty of a future expenditure. Thus, future payments to employees for work to be performed in the future, and the purchases of materials to be made in the future might be reported in the balance sheet. Is this desirable? As it does not fit the purpose for which the balance sheet is prepared, it is not. The purpose of the balance sheet is to show what economic resources the firm now has that will contribute to the future operations of the firm. It also shows the existing interests of certain external parties in the firm. The future employee services, the future purchases of materials, and future dividends are not resources or equities that are in existence now. They cannot be
considered as resources which the firm has a right to use, or as obligations which must be met.

The characteristics which give an asset value are; the right of the firm to use an item in the production of future revenue, and the legal backing to enforce that right. The characteristics which give rise to a liability are an existing legal commitment and the certainty that it will be met.

Future assets and the claims which others will have as a result of providing the future assets do not belong on the balance sheet. The contribution to revenues that the future assets will make is not something which the firm has a right to, today. As the firm does not have a right to the assets, it cannot be said that the other parties have any claims against the firm.

Application of the Definition to Obligations Affecting Only the Balance Sheet

**Leases**

Currently the propriety of reporting long-term leases in the balance sheet is being debated.
The growth of leasing in the postwar period has been phenomenal. It represents a substantial commitment of future funds by American enterprise for plant and equipment to be used now and in the future. The discussions have focused on "financing" leases.

Many businesses, in order to free funds for more productive assets contract, with organizations willing to build to suit the needs of the business, for the appropriate facilities on a rental basis. The contracts call for periodic payments by the tenants in amounts sufficient to cover the cost of the facilities, and allow the owner to earn an appropriate profit. Customarily the renter will maintain the facilities and pay the property taxes. At the end of the lease period the renter usually has the option to purchase the facilities at a nominal price or continue leasing at a substantially lower rental.

Current accounting requires that these leases be reported in a footnote if they are longer than three years and the annual rental is material. There is no
provision for the reporting in the balance sheet, of an asset or a liability.\textsuperscript{5}

The proponents of recording the long-term lease commitments as an asset and a corresponding liability support their position in the following manner.\textsuperscript{6} The renter agrees to lease the facilities for a term approximately equal to the useful life of the asset, and can acquire it at the end of the lease for a nominal sum. The renter acquires essentially the full value of the asset being rented, which is no different than if he owned the item. Outright legal ownership would offer no additional advantages. Thus the renter has, in reality, an asset.


The commitment to make periodic payments is similar to sinking fund (or serial bond retirements) and interest payment requirements. In fact, the contract is drawn up in such a way as to provide the legal owner of the facilities with a return of his principal and a profit (interest) on his investment.

Analyzed in the above terms a "financing" lease arrangement appears to be nothing more than the purchase of an asset via long-term credit. The popularity of the leasing device may be due to the fact that it is a debt-type transaction which doesn't appear on the balance sheet.\textsuperscript{7}

The opponents present the following arguments in support of their position.\textsuperscript{8} The valuation to be placed upon the agreement is arbitrary and may have little relation to the amount legally enforceable. Valuation is not of primary concern here, but the assumption upon which this objection is based is of concern here.

\textsuperscript{7}Hennessy, p. 44. \textsuperscript{8}Zises, pp. 37-47.
They point out, properly, that in the event of financial difficulty (voluntary reorganization or bankruptcy) the amount which may have to be paid has no relation to the total contract. The argument has no force for ordinary reporting purposes because it assumes a concern in a state of financial distress. Ordinary reports are prepared on a going concern basis, and for the going concern bankruptcy values are of no significance.

The other major argument is that the capitalization of leases will open the way for the recognition of all commitments, and therefore will distort the basic concept of the balance sheet. As Zises sees it, the balance sheet should report "merely what is owned or owed, . . ." The subsequent analysis will show that the proper interpretation of what is "owned," which includes lease rights, does not change the basic concept of the balance sheet. Nor does the author's definition of liabilities, which would include lease obligations, change it.

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9Zises, p. 47.
There is a failure of both to see the important aspect not only of long-term financing leases, but of any arrangement in which resources are rented rather than owned. The value to an enterprise of its assets is not based in the legal ownership of the items in question. The value of anything is in its ability to create or contribute to the creation of revenues for the enterprise. Therefore, whether we own or rent a machine or plant is not significant. What is significant is that the firm now holds rights to it which the firm can use to produce revenue in the future. This fits the definition of assets suggested in Chapter II.

The accounting process is based upon a "double-entry" system. Thus each transaction has two identifiable aspects. In the case just described one aspect of the transaction has been identified as an asset. It remains then to identify the other aspect of the transaction.

An asset can be acquired in only four ways. It can be donated to the firm; be acquired in exchange for an ownership interest; be received in exchange for other assets; and finally it can be acquired in exchange
for a promise to pay in future periods. Obviously the first three ways are not appropriate, leaving then only the promise to pay.

Is the promise to pay a debt which should be recognizable for the balance sheet purposes? Legally the total contract cannot be called a debt because the periodic payments of rent are a condition of continued use of the leased item; and the continuation of the periodic payments is conditioned upon the continued use of the leased item.

From an accounting standpoint, however, it can and should be argued that commitments under short-term or long-term leases are liabilities to be reported in the statements. From a going concern standpoint there is certainty that the firm will pay in accordance with the agreement. There is also certainty that the lessor will perform in accordance with the agreement. The certainty rests on two grounds. First, the lessor has a legal commitment to provide the item for the agreed upon period (assuming the rent is paid in accordance with the agreement). Second (perhaps more pragmatic), the lessee usually has possession of the item, thus
assuring him of its use. Therefore, it has the two important characteristics; there is reasonable certainty of payment and it has the backing of the law.

Other Types of Commitments

The lease is only one example of a number of contracts which businesses negotiate, in which neither of the parties has fully performed. Examples of apparently similar contracts are; pension agreements, purchase commitments, and personal service contracts.

There are possibly two differences between these and leases. First, in the case of the lease the lessee has physical control over the item which the lessor is bound, by the terms of the agreement, to provide. Second, it is evident that "lease financing" is a substitute for ownership and therefore the substance rather than the appearance should control.

The differences are not important. It was previously demonstrated that the basis for recognition of an asset is its economic usefulness to the enterprise, not the legal ownership. Furthermore the certainty of performance by the other party is only reinforced by the
physical control. The certainty of performance is assumed, otherwise the firms would never have made the contract.

Purchase commitments, and personal service contracts should be reported on the balance sheet. The reasoning here is the same as in the case of leases. The enterprise has an economic resource in each case.

This is demonstrated by realizing that the claim upon another has most of the advantages and disadvantages of having the item claimed. One of the dangers of holding inventory is that the price at which it can be acquired declines. The same danger exists when a firm has a purchase commitment. The advantage of having inventory when replacement prices increase is received when holding a purchase commitment.¹⁰ (The same analysis can be applied to the personal service contract.)

The firm has an economic resource. The question of how the firm got it arises. The firm received it in exchange for a promise to pay in the future. This fits the definition of a liability proposed in this chapter. It is a legal obligation, which has certainty of being honored.

**Pension Agreements**

The pension agreement poses a somewhat more difficult problem. The pension agreement is made in contemplation of a service to be received in the future. Under the usual accounting procedures the liability arising from such a commitment will be accrued as the service is received. Therefore if a pension agreement was in existence from the day a firm entered business it would recognize the liability to pay into a trust fund, or to an insurance company as the employees worked for the company.

The complicating factor is past-service costs. Pension plans normally determine the payment of pensions to employees based on their years of service with the firm, and not just the years since the inception of the
pension plan. The contributions to the plan by the employer are also based on the years-in-service of the employees. Thus, at the date the plan is adopted the firm becomes obligated to make contributions based on the past service, as well as contributions for current service. The amount of the contribution for past service cost is substantial and therefore should be reported to the stockholders.

The manner in which it is to be presented is of concern here. The obligation is clearly a liability within the accounting and legal meaning of liability. To the extent that employees have a vested interest in the plan, there is a legal debt equal to the unpaid portion of the past-service costs.

The firm seems to have only two options. It can report the entire obligation as a liability, and recognize a deferred charge for the corresponding debit. Or, it can report only that portion which is a legal debt, the unpaid part of the pension rights which have vested, again recognizing a deferred charge for the debit part of the entry. Neither alternative is proper.
A deferred charge is an asset. Therefore, it represents something of value to which the firm has a present legal right. The pension agreement does not require the employees to remain with the firm in the future. Thus, one of the two characteristics of an asset is lacking, (i.e., the present legal right to future services) and the deferred charge cannot be called an asset.

The solution to the problem is easy. The pension costs (whether based solely on current employment, or current and past employment) are related to the services now being received. As the employees work a liability is accrued. In the early years of the plan the liability would accrue at a faster rate than the later years because the contributions related to the employees with past-service would be higher than those related to the employees with no past-service.

The problem then is not one of recognizing the existence of a reportable liability, but the valuation of it. The proposed method would value it at less than the legal value. This is not improper so long as the legal obligation is reported parenthetically or in a
footnote. The presentation of bonds payable at the face value less the discount is a similar procedure.

If an employee, who has a vested interest, should quit before the past service contributions for his pension have been paid the firm must recognize on the books and in the statements a liability equal to that amount. The amount should be recognized as a loss of the period in which the employee quits, for it is a liability incurred without either an asset or an expense being received.

Sales Orders

Among the important items in analyzing an enterprise are the current orders and advance orders for its services and/or products. Financial analysis is not concerned with past performance per se. It is concerned primarily with predicting future performance. Sales orders "on the books" is one of many clues to activity in the near future.

Companies should report this information to stockholders as it is certainly important in appraising the firm. The manner by which it is presented is open
to question. It can be included in the President's letter, or perhaps in the financial summary. It might also be included in the balance sheet if it can be shown that the seller has an asset and a liability.

A sales order represents a contract between the buyer and seller. The selling firm may first require approval by the credit department and perhaps by the sales manager before a legal contract exists. Once it is a contract, however, the seller may be legally forced to perform or be required to pay damages for failure to perform.

From a legal standpoint no debt exists at this point. No party has performed. The seller has a legal liability to perform, and the buyer has a legal liability to pay; but neither has a debt.

The seller has a legal obligation. There is also certainty that he will perform. The certainty is based on three conditions: (1) He has a legal obligation; (2) he entered the agreement voluntarily; (3) if he wants repeat business he will honor this commitment. Therefore the obligation fits the proposed definition of a liability.
A further test that a recognizable transaction has occurred is to identify the other half of the transaction. If a liability has been incurred it must result in an asset, or an expense, or a loss to the firm. The firm receives a promise which has value, for there is reasonable certainty that the buyer will perform. The thing of value received did not create, or contribute to, expense. The thing of value, which exists now, will contribute to the revenues of a future period, therefore it is an asset. (As it will contribute to revenues it is not a loss.)

We have identified both aspects of the transaction as falling within classifications appropriate for reporting on the balance sheet. Therefore it should be reported.

If it is recognized that the seller has a liability, then it would seem that the buyer must have an asset. The seller's acceptance and the legal basis of the buyer's order establishes the certainty of performance. The seller's promise is a thing of value to the buyer because it will contribute to the production of future revenues. The delivery of the goods or
service changes only the nature of the asset; the economic resource is in existence before the delivery by the seller.

Does the buyer have an accounting liability? As a result of his contract with the seller, he is committed to pay the seller for the goods, if the seller delivers. Since there is sufficient certainty that the seller will deliver, and that the buyer will have to meet this commitment, the commitment has a legal basis; thus he has a liability.

The order of performance referred to in Chapter III (pages 37-38) might lead one to conclude that only the party who must perform first should report the obligation on the balance sheet. The conclusion would be erroneous, however. The sales agreement gives each party an asset, for each has a promise that is valuable and reasonably certain of being fulfilled. The source of each of the assets is an outsider, one to whom a promise has been made. The promise has a legal basis, and is reasonably certain to be met, therefore each promise is a liability within the proposed definition.
Purchase Orders

Suppose that a firm, as a normal procedure, sends a signed purchase order requesting certain goods to be delivered. The usual purchase order requests shipment by certain dates, states the F.O.B. arrangement, spells out the credit terms, and specifies a price. Does the purchaser commit himself by mailing the purchase order?

According to contract law there would be no contract until there was agreement between the parties. The acceptance might be indicated by the seller's acknowledgment and acceptance of the order. It might also be accepted by shipment of the goods, (a unilateral contract). Therefore no legal debt or liability would exist at the date of the mailing of the purchase order. Since there is no legal basis for a claim, the mailing of a purchase order does not create a reportable liability. If, however, a purchase order requiring no acknowledgment was filled by the seller before the end of the buyer's fiscal period, and not received by the buyer until after the end of the fiscal period, the buyer would have a reportable liability as of the end
of the fiscal year. This would be true regardless of the fact the goods were shipped F.O.B. destination, for the shipment would establish the contract and the certainty of performance, and therefore create a liability. Acknowledged purchase orders would be liabilities. They are like purchase commitments.

Summary

The proposed definition would require firms to report the obligations arising from contractual commitments, where there is certainty that the obligation must be met, as liabilities in the balance sheet. The broadening of the current accounting definition to the one proposed here permits the recognition of items, in the statements, which have always had the characteristics of assets, but heretofore have been presented in footnote form only.

Application of the Definition to Obligations and Accounts Affecting the Balance Sheet and the Income Statement

Generally there is a need to make adjustments to the statements at the year end. Various accruals are necessary in order to bring the books up-to-date,
and to recognize changes in certain assets and liabilities. The adjustments are of two kinds. One type is based on the recognition that certain obligations have been incurred that must be recognized. The other is based on the fact that changes in the value of some assets are not recorded, automatically. Both kinds of adjustments find their way into the liabilities section of the balance sheet. Only the former should be found there.

In order to test the applicability of the definition to the accounts and obligations affecting both statements, the following list of accounts is used. They represent a summary of most of the accounts classified as non-owners' equity by some seventy-five companies. The assumption, therefore, is that the firms considered them as liabilities rather than contra-assets, or retained earnings appropriations.

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11 The annual reports examined are reported in Appendix I. The basis for selection is explained in Appendix II.
Accounts Arising From Contractual Agreements

Deferred Credits--Revenue Received in Advance
Interest Payable
Accrued Royalties Payable
Additional Costs on Contracts
Dealers Reserves
Deferred Service Contract Income
Estimated Additional Payments to Beet Growers
Service Warranties
Employee Benefit Plans:
Deferred Payment Plan
Accrued Salaries, Wages, Vacation, and Other Compensation Allowance
Deferred Compensation Under Profit Sharing
Accrued Retirement Benefit Plans Expense

Accounts Arising From Statutory Provisions

State Income Taxes
Federal Income Taxes
Taxes Payable
Reserve for Deferred Federal Income Taxes
Reserves for Workmen's Compensation

Accounts Arising Solely from Inter-Period Income Adjustments

Provision for the Replacement of "LIFO" Inventories
Reserve for Reduction of Normal Inventory to Fixed Prices
Reserve for Building Repair and Other Estimated Expenses (Future Plant Relocation)
Reserve for Insurance
Reserve for Foreign Investments
Reserve for Contingencies
NON-OWNERS' EQUITY ACCOUNTS (Continued)

Accounts Not Sufficiently Explained to Identify

Deferred Income
Reserves--Other
Unrealized Profits
Deferred Credits to Income
Deferred Liabilities and Reserves
Operating Reserves
Deferred Credits, Reserves, and Non-Current Liabilities

Contractual Obligations

The obligations arising from contracts are included in the expanded accounting definition. Even the current accounting definition would call them liabilities. In spite of this fact, under the current accounting definition certain classes are often overlooked.

The recognition of accrued wages, accrued interest, and even unbilled, but consumed services, occurs in the ordinary course of accounting activity. However, there is often failure to recognize that part of the sales dollar which is really earned in future periods, or, alternatively, that expense to be incurred in future periods which must be related to the revenues
of the current period. For example, consider product guarantees. Most companies offer a guarantee with their products. Yet of the 600 companies reviewed by the Institute only 23 explicitly recognized a "reserve for product guarantee."12

Statutory Obligations

The obligations arising out of legislative assessments also fit the proposed, as well as the present accounting definition. One account, however, has been the center of controversy—the "Reserve for Deferred Federal Income Taxes."

The "Reserve for Deferred Federal Income Tax" arises primarily from a conflict between the tax law and common accounting procedures for depreciation. The tax law permits a taxpayer to accelerate the depreciation charges by taking more depreciation in the early years and less in the later years. When the taxpayer uses straight-line depreciation for reporting purposes and accelerated depreciation for tax purposes,

12Accounting Trends and Techniques - 1960, p. 106.
there is a difference between the tax that is to be paid and the tax that would have been paid if straight-line depreciation had been used for both.

If one asset is considered it is clear that all that has happened has been the shifting of the payment of the tax to a future period. Then in the words of the Committee on Accounting Procedure,

recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, . . . \(^\text{13}\)

Firms have more than one asset. When the deferral is occurring on many assets the problem appears more complex.

The acceleration of depreciation was permissible beginning with new depreciable assets, having a life greater than two years, acquired after December 31, 1953. \(^\text{14}\) If a firm chose to use an accelerated method for all new depreciable assets acquired after that

\(^{13}\)Accounting Research Bulletin Number 44 (revised), p. 3.

\(^{14}\)Section 167 of the Internal Revenue Code of 1954.
date and followed the Committee on Accounting Procedure's recommendation that the deferred tax be recognized in the accounts, the deferred tax account would grow larger for several years.

If the firm were continuously expanding, the size of the account would continue to grow. If the firm were stable and replaced depreciable assets at a fairly uniform rate, the balance of the account would remain at the amount reached several years after the adoption of the accelerated methods.

The stability of this amount, or its growing character in expanding firms has caused concern among accountants. It has led some to conclude that it cannot be a liability because there is no determinable payment date.15 Many utility companies favor this position. Footnote disclosure, or an appropriation of retained earnings is considered adequate.

An analysis of the "Reserve for Deferred Taxes" account will show that entries of the current period are net entries. Assets acquired in earlier years have now reached the stage where the depreciation charges are less than they would have been under straight-line and higher taxes are being paid. That is offset, however, by the tax-saving on newly acquired assets. As a result the balance of the account may not be diminishing. As of any point in time, however, a schedule can be prepared showing exactly when the amount now shown on the books will be paid, assuming no change in the tax laws and future income.

Another point of view, the one supported by the Committee on Accounting Procedure and the Securities and Exchange Commission, recommends presentation of this account as a liability. Willard Graham sums up the arguments supporting the liability classification. The intent of the Congress in enacting Section 167 was to

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permit the deferral of tax payments. The tax is paid in all cases. It is paid in later years of life of the asset, or if the asset is sold payment is made in the form of tax on the increased gain.\(^{17}\)

The only case where the deferred payment is not made would be one in which the company incurs losses on future operations. Under the carryback and carry-forward provisions of the tax code, however, the tax would be paid because the refunds claimed would be less than if straight-line depreciation had been used throughout the life of the assets. Therefore even certain future losses would not preclude the payment of the deferred taxes in most instances.

Assume that the life of an asset is eight years. Depreciation for tax purposes is accelerated. During each of the first four years of life taxable income comes out close to zero. During the last four years of the life of the asset taxable income is negative, at least equal to the difference between the tax

depreciation amount and straight-line depreciation amount for the last four years. And finally the five years subsequent to the end of the useful life of the asset show little or no taxable profit. Only under these very special conditions, thirteen consecutive years of little or no taxable income (which would mean little or no profit in the typical accounting sense) would there be no payment of deferred taxes.

The third alternative would be to consider the credit as a contra to depreciable assets. To support this position income taxes must be an expense, and they must be an expense which is directly associated with the operating costs of the asset. There has been some controversy in accounting surrounding the proper classification of income taxes. Some say they are a distribution of income. Others say they are an expense.18 There is no need to settle that dispute here.

If they are distributions of income then they

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cannot be associated with the operating costs of depreciable assets. Then it follows that the deferred taxes can't be a contra-asset. If they are expenses, then they must be associated with the cost of operating the depreciable asset in order to affect the valuation of the asset.

Income taxes cannot be a part of the total costs of operating a fixed asset. The income tax is assessed upon the income of the firm. The income of the firm is determined by the net result of all of the expenses and revenues. It does not seem appropriate, therefore, to trace the effect of one expense, depreciation, on the taxes. If the tax is not associated specifically with the contribution of the depreciable asset to the period then the deferred tax cannot be considered a valuation account of the assets.

The remaining difficulty is whether the emergence of business income is the basis for saying that the tax is owed. It might seem reasonable to say that the tax is due and chargeable to the period for which the tax is computed. Such a position is not reasonable. The tax is computed on the income of the firm.
The difference between taxable income and business income is usually caused by a difference in timing. The tax laws require prepaid revenue to be taxed in the period received, rather than the period earned. The law permits depreciation charges higher in amount in the early years of the asset's life than would be used for business income measurement; and, of course, lower in the later years. All income is taxed, the only uncertainty is the period in which the tax must be paid. Therefore the tax charge should be related to the period in which the income is earned. The computation of the tax due in a particular period indicates when the tax is to be paid, not what is to be taxed. The deferred federal income tax arising from using accelerated depreciation is properly reported as a liability.

The 'Reserve for Workmen's Compensation' requires a brief mention. Companies, in many states, have the choice of insuring against employee accidents, or paying for them as they occur. This is one kind of "self-insurance" that can properly be recorded as a liability. The state imposes a duty on the employer to pay certain
amounts to employees who cannot work because of injuries received on the job. This, plus the realization that awards will be made in the future on injuries occurring in the present period, places the "Reserve for Workmen's Compensation" within the proposed definition.

**Accounts Arising Solely from Inter-period Income Adjustments**

One charge that theoreticians are apt to levy against practitioners who engage in inter-period allocation of revenue and expense is that the practitioners are attempting to smooth reported income, to which the practitioners may reply that matching of expense and revenue requires that the adjustments be made. It is obvious that the line between income-smoothing and the matching of expense and revenue is not clearly marked.

Is the recognition of a charge against revenue for repair on new equipment, when the repairs will not actually occur until some future period, income-smoothing or matching? The answer is dependent upon whether or not repair and maintenance expenses build up with the passage of time. If they do then the current period should be charged with some share of the expenditures.
to be made in the future. Otherwise they are a charge of the period in which the repairs are made.

Once it is decided that such an item is to be spread over several years there remains the treatment of the credit part of the adjustment. We can eliminate only one of the three alternatives immediately. Present rules of accounting do not permit the increase in a retained earnings appropriation to be caused by a charge against revenues. Thus the credit amount is either a contra-asset, or a liability.

The accounts are not liabilities. They do not fit the definition of liabilities suggested by current accounting theory, nor do they fit the proposed definition. Although they may be certain to require the use of assets in the future, they are not caused by legal obligations. If the accounts are necessary, and proper for the measurement of income, their justification must lie in asset valuation.

**Reserves for losses.** Present accounting rules allow the recognition of a loss in the accounts before
it is actually realized.\textsuperscript{19} Therefore, if assets appearing on the balance sheet are worth less than their remaining cost value (in terms of economic benefit to the firm), they are written down to the new lower value. The "cost or market, whichever is lower" rule applied to inventories is an example.

The losses are related to existing assets and thus should be credited to the assets or to a contra-asset account. If they are uncertain then they should be appropriations of retained earnings.

"Reserves for foreign investment," and "for inventory price declines" should be deducted from the asset if there has been an actual decline in value. Otherwise they are merely to put the reader on notice that the company is prepared for the losses, should they occur. Footnote disclosures or retained earnings appropriations are the way to display possible occurrences which may affect future operations.

The nebulous account "Reserve for Contingencies" serves no useful purpose in accounting. If the certainty

\textsuperscript{19} Finney and Miller, \textit{Intermediate}, p. 251.
of the contingency occurring is great then it should be recognized in the accounts and be more clearly identified. If, on the other hand, it is merely an amount which is set up to cover unknown future occurrences which have no connection with the present then the retained earnings appropriation is the least offensive way to report it. It would better not be shown at all, as the entire stockholders' equity serves this function.

The "Reserve for Self-Insurance" account can cover more than one kind of insurance. Casualty losses which cause outsiders, customers or employees, to make claims against the firm may be appropriate for recognition as liabilities. The "self-insurance" against the fire losses, or flood losses which do not represent outsiders' claims do not have the characteristics necessary for recognition as a liability.

The claims to be paid under workmen's compensation laws or public liability suits should be charged to the period in which the cause of the claim occurred. As many of the claims will not be filed or settled in
the year of the accident, waiting for the period of payment would not match expenses and revenues.

In the larger enterprises the certainty of payment of some, if not all, of the claims is great enough to allow its recognition. In addition there is an outsider making the claim; the claims as a group have legal force and they are related to a period which has passed. On these grounds they can be considered a liability.

"Self-insurance" against fire and other future insurable losses is done instead of paying an outsider for protection against the risk of loss due to fire. The term "self-insurance" is contradictory, but it is the term used to describe those cases where a firm does not buy insurance to cover insurable risks.

There are two questions which must be answered. If a company "self-insures," does it have a reportable liability? If the answer to this is no, then is there a decline in the future usefulness of the asset which would call for a contra-asset account? The answer to both questions is no.
The argument that comparison of firms requires those "self-insuring" to recognize an expense in order that the expenses of the several companies be comparable is not sound. For the companies which take the risk themselves should show more income in the periods in which no loss occurs because their expenses are lower. Furthermore, if a company "self-insures" and suffers no losses during its existence, or losses totaling less than the insurance premiums other firms might have paid, it should report more income, for it has earned more income. The company which is paying insurance premiums is not prepaying for future losses. Rather they are paying for protection against economic loss in specified periods of time. Once the period has passed the economic benefit from the insurance premium has also passed.

There is no liability within the expanded legal-accounting definition. Future losses are not connected with past events, and there are no existing legal claims. Therefore, even if there were certainty of occurrence and the possibility that an external party might present the claim no liability can be recognized.
The credit cannot be a contra-asset either (referring to fire losses). The periodic charges arising from the use of an asset are the difference between its future economic usefulness at the beginning and its future economic usefulness at the end of the year. The remote possibility of a fire loss, which is not caused by or related to the current period's consumption of its economic usefulness, cannot be said to contribute to the decline in its future economic usefulness. Therefore the possibility of a future loss does not affect its present valuation.

All that is left for companies wishing to show that they "self-insure" is footnote disclosure or an appropriation of retained earnings.

**LIFO Inventory Reserves.** LIFO inventory reserves arise from two causes. The desire to include inventory among the current assets at FIFO value or some value other than LIFO, and use LIFO for income determination is one. The other is caused by a temporary liquidation of inventories.

The former is obviously a contra-asset account. Its title and purpose clearly indicate that it is an
adjustment of the inventory value. Thus its proper place is as a deduction from inventory and not as a liability.

The "replacement" reserve is not disposed of as easily. The proponents of the LIFO method support their position by pointing out that LIFO matches current costs and current revenues. It would defeat the purpose of LIFO if the users were forced to include in the expenses the old (often very old) costs included in inventory if the decline in the physical inventory at the balance sheet date were temporary. The inventory is valued correctly—in terms of LIFO method. So the "reserve" can't be a contra-asset.

The "reserve" does not meet the criteria for a liability. Even though the replacement is certain, it does not rise from an existing contractual or a statutory obligation. The only feasible conclusion is that the LIFO method can not be an acceptable method for inventory valuation. A valuation method which does not satisfy both balance sheet and income statement requirements is not acceptable. The balance sheet and income statements are inter-related. To use a method
of valuation requiring adjustments which have no place on one of the two statements is to deny the inter-relation­ship.

**Reserves for future expenses.** The reserves for "repair and maintenance" and for "collection expenses on present receivables" arise from the recognition that expenditures in the future periods are caused by activities in the present period. That they should be included as charges against current revenue is obvious. If they contribute to current revenues the proper matching can be accomplished only if they are included among the current expenses.

The credits can not be said to be liabilities however, as they do not arise from existing contractual or statutory obligations. The only alternative is for them to be contra-assets. This is a supportable position.

A depreciable asset contributes, or is capable of contributing, services to each of the periods of its useful life. The cost charged to each period should conform to this pattern of services. The depreciation charges should vary so as to allow the total cost,
primarily depreciation plus repair and maintenance, to conform to the appropriate pattern. Therefore a "reserve for repair and maintenance" would be necessary only in those cases where the wrong method of depreciation was chosen. Thus the "reserve" would be an adjustment of the depreciation credit for the period.

Receivables are valued at their realizable amount. The collection expenses would have to be considered in determining the realizable value. For most receivables the cost of collection is negligible and would not be significant in the valuation. For those receivables where collection expenses are significant (slow accounts and installment receivables) recognition of the expense and the lower realizable value is appropriate.

The expenses to be incurred in the future from plant relocation are not properly charged against current and past revenues. They are costs which should be charged to the future periods when the benefits from the relocation are received. They do not arise from commitments made currently, but from commitments
to be made at some future date. Therefore they are not liabilities to be reported on present balance sheets.

Preferred Stock

From an accounting standpoint as well as from a legal standpoint, the promise to pay is the controlling factor in the definition of a liability. When capital is raised by securities whose provisions require a return of principal, as well as a return for the use of principal, the security should be classified as a liability. The distinction between debt and ownership is based upon the expectation, expressed in the contractual arrangement between the capital provider and the enterprise, that the principal investment will be repaid on the debt capital and not on the ownership capital.

The name of the security should not be controlling. If a security called preferred stock has the primary characteristic associated with debt, then it should be classified with the liabilities. Redeemable
preferred stock has the primary characteristic of debt securities—repayment of the principal.

The legal cloud which exists over the right of preferred stockholders to enforce their claim may cause the alternative conclusion in some cases. If the state law does not permit the repurchase of stock, or if it restricts it to the amount of surplus and there is no prospect of surplus, then the preferred stock should be a part of the owners' equity.

A preferred stock which is callable at the firm's option, and there is no specific date by which the entire issue is to be retired, does not meet the test. The preferred stock contract must indicate the intention of the firm to retire the stock and specify a retirement date.
CHAPTER VI

SUMMARY

There is a generally accepted concept of liabilities for financial reporting purposes. All obligations of the firm which are legal debts; all obligations which are not legal debts when taken one by one, but when considered in total have the characteristics of debt; and the credit balances arising from inter-period adjustments which are not traditionally contra-assets, are reported on balance sheets as non-owners' equity items.

It is true that not all authorities or practitioners would agree that this is the generally accepted concept of liabilities. However, it is the opinion of the author, based upon a review of accounting literature and financial reports that it represents the total position of the accounting profession.

Accounting theory generally accepts the first parts of the concept, the legal debts and the quasi-
debts. It does not accept the treatment of non-legal basis inter-period adjustments as liabilities.

Accounting practice follows, in general, the present theoretical concept plus the non-legal basis inter-period adjustments. The financial reports consistently include either a "reserves" section or "reserve" accounts above the owners' equity section. Some of the "reserves" are actually quasi-debts and fit the theoretical concept. However, a number are either contra-assets or retained earnings appropriations and should not be shown as a part of the liabilities. But it is common for these to be shown as liabilities. Thus they may be included in the generally accepted concept.

The concept is not suitable for modern corporate purposes. It fails in two ways. It is not broad enough in the area of the types of obligations which are included as liabilities, and it includes credit balances for non-legal basis inter-period adjustments which cannot be said to constitute liabilities in any meaningful sense of the word.
It is not suitable because it leaves out of the position statement commitments which the firm most certainly will honor. Complementary to this it causes economic resources to be left off the balance sheet.

The presentation of the credit balance arising from non-contractual inter-period adjustments as a liability has the effect of over-stating the assets and the liabilities. The inter-period adjustments which can be justified by matching revenue and expense can be shown to be contra-assets or liability adjunct accounts (i.e., bond premium) and not liabilities. Those which cannot be justified for this reason do not belong among the liabilities nor among contra-assets. They should be retained earnings appropriations.

The definition presented in Chapter V, and restated here, is more suitable for corporate financial reports:

A liability is any commitment or obligation which has a legal basis, and is reasonably certain to be honored. The legal basis may arise from a contract, a legislative assessment, or a court decision.
This definition requires the firm to recognize that it has an obligation to perform at the time it obligates itself. The present concept ignores the fact the party to perform first has a liability until the performance. It does not recognize a liability on the part of the party receiving the performance until after performance occurs.

Thus, the present concept ignores the realities of business activity. The obligation arises from the agreement between parties, it does not arise solely from the performance. It is true that the party receiving the promise of performance ordinarily does not fulfill his part of the bargain until he receives the act required. However, he must be prepared to fulfill his obligation if the other party performs. It is a normal expectation in a business contract that the other party will do what he has promised.

There are two parts to the definition, both of which must be satisfied before an item can be called a liability. There must be a legal basis underlying the claim. There must be, also, reasonable certainty that the claim will be exercised.
Executory contracts where the party required to perform first is not expected to do so would not be recorded as a liability by the party who was to receive the performance. The amount expected to be received as damages, if measurable, would be recorded as an asset with the credit reducing the increased cost of acquiring the service or goods elsewhere. The party who breaches the contract would have to show a liability equal to the expected damages arising from the breach.

The credit balances arising from non-legal basis inter-period adjustments which may require the disbursement of funds at some future date are not liabilities. They lack the legal basis requirement. In many cases the certainty of performance is as great but the actual performance is not unalterably required as a result of present activity, and thus it is outside the scope of a liability. They may be required for proper income measurement, and the effect of these items upon income measurement may be significant. This can be accomplished in a more satisfactory manner by the asset valuation techniques available.
The following list presents liabilities which are not currently included in the balance sheet, which the author as a result of this study, believes should be. It also includes accounts now reported as liabilities which he feels shouldn't be.

RECOMMENDATIONS REGARDING THE INCLUSION IN AND EXCLUSION OF SPECIFIC ACCOUNTS FROM THE BALANCE SHEET

Obligations and Commitments, Currently Excluded from the Balance Sheet, Now to be Included

- Long-term Leases
- Short-term Leases
- Purchase Commitments
- Signed Sales Orders
- Acknowledged Purchased Orders
- Purchase Orders Shipped
- Personal Service Contracts
- Pension Agreements
- Deferred Federal Income Taxes
- Redeemable Preferred Stock

Accounts, Currently Reported as Liabilities in the Balance Sheet, Which Should be Excluded

- Reserves for Future Losses
- Reserves for Future Expenses
- Asset Valuation Reserves
- Reserve for Replacement of LIFO Inventories
Whether accounting theory and practice will develop along the lines suggested here is difficult to determine. The considerable attention paid to leases would seem to indicate a movement in this direction. However, the present emphasis of matching revenue and expense without consideration of the effect on the balance sheet may be stronger.

The adoption of the proposed definition will improve corporate financial statements. It will do so because it will cause things of value, which currently are left off the balance sheet, to be reported with the assets now shown in the balance sheet. In addition, it will remove any accounts arising from inter-period adjustments from the liabilities classification where those accounts do not have foundation in a legal arrangement. Finally it will require the reporting of all commitments and obligations arising from legal agreements, taxation statutes, and court proceedings.
APPENDIX I

The annual reports examined as a part of this study are listed here. They are the reports for fiscal years ending in 1959, except as otherwise noted. In order to insure broad coverage the list of reports to be examined was made up of one company from almost every category in Standard and Poor's 500 Stock Index.

ACF-Wrigley Stores, Inc. (June 25, 1960)
Alpha Portland Cement Company
Aluminum Company of America
Amerada Petroleum Corporation
American Airlines, Inc.
American Brake Shoe Company
American Can Company
American Chicle Company
American Express Company
American Motors Corporation
American Natural Gas Company
American Radiator & Standard Sanitary Corporation
American Smelting and Refining Company
American Sugar Refining Company
American Telephone and Telegraph Company
American Viscose Corporation
American Zinc, Lead and Smelting Company
The Amaconda Company
Armco Steel Corporation
Armour and Company
The Babcock & Wilcox Company
Baltimore Gas & Electric Company
Bath Iron Works Corporation
Bigelow-Sanford Carpet Company
Boeing Airplane Company
The Borden Company
Bristol-Myers Company
Brown Shoe Company (October 31, 1960)
The Budd Company
Burroughs Corporation
C I T Financial Corporation
Canada Dry Corporation
Cannon Mills Company
Caterpillar Tractor Company
Central Aguirre Sugar Company
Chain Belt Company
Champion Paper and Fibre Company
The Cincinnati Milling Machine Company
Clark Equipment Company
Cluett, Peabody & Co., Inc.
Colgate-Palmolive Company
Columbia Broadcasting System, Inc.
Container Corporation of America
Corn Products Company
The Cuneo Press, Inc.
Deere and Company
Divco-Wayne Corporation
Dome Mines Limited (A Canadian Corporation)
Dresser Industries, Inc.
Eastman Kodak Company
Federated Department Stores, Inc.
The Firestone Tire and Rubber Company
Freeport Sulphur Company
General Baking Company
General Cigar Co., Inc.
General Foods Corporation
Goebel Brewing Company
The Great Western Sugar Company
H. J. Heinz Company
Hiram Walker-Gooderham & Worts (A Canadian Corporation)
International Minerals & Chemical Corporation
The International Nickel Company of Canada, Limited
Island Creek Coal Company
S. S. Kresge Company
Liggett & Meyers Tobacco Company, Inc.
Litton Industries, Inc.
Olin Mathieson Chemical Corporation
Panhandle Eastern Pipe Line Company
Scovill Manufacturing Company
Sears, Roebuck and Co.
Shell Oil Company
Spencer Kellogg and Sons, Inc.
Sunshine Biscuit, Inc.
Texaco, Inc.
20th Century-Fox Film Corporation
Whirlpool Corporation
Zenith Radio Corporation
APPENDIX II

The accounts presented on pages 100-101 do not represent all the non-owners' equity accounts reported in the annual reports. The accounts were used to test the proposed definition. The accounts which represented legal debts, and whose primary effect was only on the balance sheet were not presented (i.e., accounts payable and notes payable). They were not presented, since they are covered in the current and proposed definition, and pose no special reporting problems.
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AUTOBIOGRAPHY

I, James Bulloch, was born in Highland Park, Michigan, June 3, 1933. I was graduated from Battle Creek Central High School, Battle Creek, Michigan. I attended the University of Michigan from 1951 to 1957, during which time I was granted a Bachelor of Business Administration in 1955, and a Master of Business Administration in 1957. In 1957 I was licensed to practice as a Certified Public Accountant by the state of Michigan. I was appointed an Instructor in the Department of Accounting, The Ohio State University, in 1957. I held this position for three years while completing some of the requirements for the Doctor of Philosophy degree. I completed the requirements for the degree in 1961, while a Lecturer in Accounting in the School of Business Administration, The University of Michigan.