A COMPARISON OF ACCOUNTING CONCEPTS AND STANDARDS EXPRESSED IN A
SELECTED GROUP OF COLLEGE TEXTBOOKS
WITH OTHER CURRENT LITERATURE

DISSERTATION

Presented in Partial Fulfillment of the Requirements
for the Degree Doctor of Philosophy in the
Graduate School of The Ohio State
University

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1953

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Efforts directed toward standardizing and improving accounting procedures did result in the publication of several bulletins during the period from 1917 to 1939. The first of these, dealing principally with auditing methods but placing considerable emphasis on accounting theory, was a booklet, "Examination of Financial Statements," issued by the Federal Reserve Board in 1917. The 1917 bulletin was revised in 1929. During this same period the Illinois Manufacturers' Cost Association issued a booklet, "Preparation and Use of Financial Statements," prepared by its committee on standardization of accounting procedures in 1921. Another pamphlet, "Audits of Corporate Accountants," issued by the American Institute of Accountants, was based upon the work of the AIA Committee on Cooperation with Stock Exchanges during the period 1932-1934.

Joining with the practitioners in activities directed toward developing more uniformity in accounting the association of teachers of accounting in various colleges and universities, the American Accounting Association published a "Tentative Statement of Accounting Principles" in 1936, which provoked a flood of written and oral comments with regard to some of the propositions advanced therein. Five years after the issuance of its "Tentative Statement," the American Accounting Association published a revision entitled "Accounting Principles Underlying Corporate Financial Statements." Again, in 1948, another revision was issued under the title "Accounting Concepts and Standards Underlying Corporate Financial Statements." Two other important publications of the Association were "A Statement of Accounting Principles," by Sanders Hatfield and Moore, which appeared in 1938, and "An Introduction to Corporate Accounting
Paton and Littleton advance arguments against the lifo method of measuring the flow of inventories. They state:

Under this conception the inventory is viewed as essentially a fixed asset, disassociated from the current flow of cost. That is, after the inventory pool has once been filled all cost factors are assumed to pass over the inventory and attach at once to sales. For business in general, without doubt, this conception does not conform to the physical conditions, and even in the fields of extraction and conversion objective conditions lend little support to the method. Moreover, if the flow of goods actually did follow the indicated pattern the loss through deterioration in the inventory would be enormous. Hence the efforts of management in general should be directed to seeing to it that the last-in, first-out order is not allowed. . . Further, while the last-in, first-out conception implies systematic procedure, it does not assume a consistent treatment for all costs incurred. Instead the first increments to the amount of the inventory are capitalized for an indefinite period whereas later increments are assumed to flit through the process of production almost instantaneously.152

Contrary to the Paton and Littleton viewpoint on lifo, an English economist, K. Lacey, advocates the use of the method as a means of encouraging economic stability. He states:

The arguments for the Lifo principle can be stated on the following lines:

(a) Our current income, i.e., the amount we now have available for spending, is represented by the current cost of present production. For example, the farmer's income is the value of raw cotton now being sold; the wage earner's income is his present weekly wage. In brief, personal incomes are forming part of the cost of replaced inventories and are not connected with the cost of finished goods already completed.

(b) Therefore selling prices and profits are best computed on the basis of current costs. Business success or failure should be judged by reference to what is reasonably possible, and a reasonable profit over current costs is more likely to be consistently earned than a profit based on the cost of the goods actually being sold. During a boom it is so easy to earn a profit based on actual cost that undue optimism is encouraged. And during a slump it is asking too much to expect to earn a profit based on actual costs, for current incomes have already been reduced to the level of current costs. 153

The position taken by the American Accounting Association in the handling of inventories is summarized in the following statement:

For purposes of determining the expense of a period, it is acceptable to assume a flow of the cost of inventoriable items, for example, "first in, first out." The residual cost should be carried forward in the balance sheet for assignment in future periods except when it is evident that the cost of an item of inventory cannot be recovered, whether from damage, deterioration, obsolescence, style change, over-supply, reduction in price levels,* or other causes. In such event the inventory items should be stated at the estimated amount of sales proceeds less direct expense of completion and disposal. This concept of residual cost may be applied to inventory items, a group of inventory items, or to the total inventory. The method of inventory costing should be consistent from period to period and should conform reasonably with practices established within the industry or trade. 154


* Underscoring supplied.
For the most part, the authors of textbooks follow the viewpoints expressed in Accounting Research Bulletin No. 29 in their presentations of inventory accounting methods. Many of them make frequent reference to statements in that bulletin. On the whole, the authors indicate their approval of the "lower of cost or market" rule as on the basis of conservatism. However, Mackenzie takes exception to this concept, stating:

> Frequently the effect of this rule is to understate the profit of the current period and to understate the inventory on the balance sheet. There would seem to be no justification for the indiscriminate application of this rule; certainly when the inventory can be sold at a profit it would seem undesirable to record it at its replacement cost simply because this cost is below actual cost. Ordinarily it is better to use actual costs. 156

With regard to "cost or market," Mason, Stenberg, and Niven express themselves in much the same manner as follows:

> Using the lower of cost or market price as the basis of inventory valuation is considered to be a "conservative" policy because (1) it allows losses to be recognized before goods are sold, but never permits profits and increases in market value to be recorded before a sale takes place, and (2) it gives an inventory figure on the balance sheet which is never greater, but may be less than actual cost. An examination, however, of the effects of its use over a series of accounting periods throws some doubt on the reasonableness of this rule of valuation. There is only one profit or loss figure—the difference between the original cost and the selling price—and it is merely a matter as to how this figure of profit or loss is to be spread over the

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accounting periods. When the lower oc cost or market is used, the net income of the present period may be lower than if original cost were used as the basis, but the net income of the next period is larger. . . This tendency will be present under any assumed or actual set of conditions. It is doubtful, then, if this rule can properly be called "conservative" and it is admittedly inconsistent. The consistent use of original cost will usually give more useful results.156

Most discussions by textbook authors of the fifo and lifo methods of inventory accounting consisted of presentations of procedures for accomplishing or examples of the effects of using either of the two methods on the reported profits, without indicating approval or disapproval of either. On the other hand, Mauriello, after a detailed comparison of the two methods, draws the following conclusions:

Lifo matches sales price and cost in terms of the same purchasing power of the dollar. As a result of matching current costs with current sales prices, Lifo stabilizes the profits reported from period to period on the income statement, with costs being increased or decreased to correspond with increased or decreased sales prices.

The stabilized profit secured by the method produces certain advantages, as follows:

1. During a period of advancing prices, earned surplus is kept free of "inventory profits," i.e., profits represented in the ending inventory value which (a) will not be realized to the extent that they apply to the fixed or normal quantity of the inventory, or (b) will disappear if sales prices go down. Further, even if costs and prices remain at a high level, the increased surplus based on the inventory profits may not be distributable as dividends.

since cash will be needed to replace the merchandise at the high cost level. Under these circumstances Lifo eliminates any delusion of considerable profits and the consequent possibility of paying excessive dividends, of undertaking unjustifiable expansion programs, or otherwise inadvisedly draining working capital.

2. For tax purposes a stabilized profit is advantageous because of graduated tax rates and the possibility of periodic legislative changes in rates.  

Finney and Miller see some definite objections to lifo. They say:

The lifo method places the emphasis on the income statement, but its effect on the balance sheet, and particularly on the working capital shown therein, should not be overlooked.

If a sustained price rise follows an adoption of the lifo method, the dollar balance reported for inventories among the current assets will be substantially less than current costs. Although the lifo advocates contend that achieving a more appropriate matching of costs against revenues is such an important objective that it offsets the "incorrect" balance sheet results, the fact remains that conceivably, inventory quantities might eventually be priced at such "old" costs as to produce a misstatement of working capital position that would be seriously misleading.  

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In spite of the present day emphasis on income determination in accounting, the balance-sheet remains an important statement. Accordingly, a significant core of concepts and standards has been developed to serve as guides in the accounting treatment of balance sheet items. With respect to assets, accounting theory centers around the following problems: a determination of the nature and characteristics of assets, classification of assets, valuation, and their disposition.

In their 1948 Statement the members of the Committee on Accounting Concepts and Standards of the American Accounting Association make the following observation:

The assets or economic resources of an enterprise are its rights in property, both tangible and intangible. The most commonly useful financial statements report the origin and disposition of the assets of an enterprise in terms of costs established and recorded at the time the assets are acquired. 159

Sanders, Hatfield and Moore, in pointing out the nature of assets, write:

The assets of a business comprise all its properties or resources. In general, three conditions apply to the listing of items as assets,

(1) that the business in question owns them, (2) that the business has acquired them at a cost, and (3) that they are of value to the business.¹⁶⁰

A number of writers have expressed the viewpoint that an asset may be considered as a deferred charge to future operations, or, in other words, an unexpired cost. In commenting on this concept, Gilman says:

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

Its helpfulness lies in the fact that it eliminates the factors of tangibility and intangibility and also the confusion between economic values, resale values, and accounting values. Expenditures are often made in the hope and expectation of a favorable effect upon any future profits. Often such effects are measurable. On the logical ideal of matching costs and revenues, the expenditures should then be considered as deductible from the future income for the encouragement of which they were made. . .

While it is common to think of some assets as being deferred charges against future profits, it is not generally recognized that all assets except cash may be considered deferred charges, i.e., some of them are deferred charges against future income, others are deferred charges to cash.¹⁶¹

That Paton and Littleton also conceive of many types of assets as being in the nature of deferred charges is expressed in the following comment:

The factors acquired for production which have not yet reached the point in the business process where they may be appropriately treated as "cost of sales" or "expense" are called "assets," and are presented as such in the balance sheet. It should not be overlooked, however, that these "assets" are in fact "revenue charges in suspense" awaiting some future matching with revenue as costs or expenses.  

In the textbooks there is virtually complete agreement in the matter of defining and pointing out the nature of assets. Mackenzie points out that it is desirable to recognize two different types of assets:

1. Certain property rights such as cash, claims for cash, and investments, and

2. Assets which are simply costs to be deducted from the revenues of future accounting periods.  

The following are typical of the definitions given by textbook authors:

An asset may be broadly defined as any consideration, material or otherwise, which is owned by a specific business enterprise (or in which the enterprise has an equitable interest) and which has a value to that enterprise.  

Assets are things of value owned.  

An asset is any property, claim, or advantage of value to a business enterprise. 

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Accountants usually classify assets into three main categories; current, fixed, and deferred charges. Other classifications indicate whether the property rights are tangible, or intangible. Certain concepts relative to accounting for fixed tangible assets have already been presented in chapters dealing with depreciation or changing price levels. Therefore, in this section emphasis will be placed on standards relative to accounting for current assets or fixed intangible assets, touching upon fixed tangible assets only where certain standards are applicable to all types of assets.

Generally in the past, items have been entered in the current asset group upon the basis of liquidity or the possibility of ready realization into cash. Recently, however, a broader interpretation is being applied to the concept of what should be considered as "current." The committee on accounting procedure of the American Institute of Accountants issued its opinion on this matter in Bulletin No. 30. In this bulletin the committee states:

The committee believes that, in the past, definitions of current assets have tended to be overly concerned with immediate or forced liquidation values.167

Embodied in the following discussion is a departure from traditional asset classification as items formerly listed under "deferred charges" are placed in the current group:

For accounting purposes, the term **current assets** is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as (a) cash available for current operations and items which are the equivalent of cash, (b) merchandise or stock on hand, or inventories of raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts, (c) trade accounts, notes, and acceptances receivable, (d) receivables from officers (other than for loans and advances), employees, affiliates, and others if collectible in the ordinary course of business within a year, (e) installment or deferred accounts and notes receivable if they conform to normal trade practices and terms within the business, (f) marketable securities representing the investment of cash available for current operations, and (g) prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance, would require the use of current assets during the operating cycle.168

The inclusion of prepaid items in the current asset category represents a contrast from a statement by Sanders, Hatfield, and Moore, about 10 years previous to the issuance of the above bulletin, which is as follows:

A few companies include prepaid expenses among current assets. Considerations of conservatism and convenience have, however, resulted in a general practice of showing deferred and prepaid items in one group, in which case none of them is treated as current. This is generally the preferable practice.169

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Standards," by Paton and Littleton, published by the American Accounting Association in 1941.

Mention should be made that there were forces outside of the accounting profession which added impetus to the search for principles. New Deal legislation resulted in increased governmental regulation of business and business procedures. One of the most potent forces for control of accounting methods resides in the office of the chief accountant of the Securities Exchange Commission, whose office was given powers to require certain practices as far as accounting procedures are concerned of companies which are subject to the Federal Securities Act of 1933 and the Federal Securities Exchange Act of 1934. Through a number of official releases on controversial issues, the SEC has exerted great influence on improving corporate accounting and reporting.

The effect of World War II and its post-war inflationary price levels focused attention on the unstable characteristics of the dollar as a unit of financial measurement. This has led to a series of articles and much current discussion concerning the reliability of the traditional methods of calculating business income. The American Accounting Association took up the issue in a statement issued by the committee on concepts and standards entitled "Price Level Changes and Financial Statements," which was published in 1951.

The most searching analysis of the problem was undertaken by the formation of a Study Group on Business Income organized in 1948 by the American Institute of Accountants by means of a grant from the Rockefeller Foundation. This study group, which was composed of accountants, lawyers, and economists, issued several monographs and wrote several magazine
It appears that most of the textbook writers are not so quick to change their methods of classification of assets to include prepaid items as current. However, a few of them are in line with the recommendations of Bulletin 30. Comments from some authors relative to this matter follow:

Many businessmen and banks have long insisted that current assets should include only readily marketable assets and, for that reason, have classified prepaid expenses either under separate heading of "Prepaid Expenses" immediately following the "Current Asset" group or under a heading of "Deferred Charges" or "Deferred Assets" as the last asset classification on the balance sheet. More recently, authoritative sources have stated that in the past too much emphasis has been placed on "immediate or forced liquidation values" as the index of debt paying ability rather than on ability to pay creditors out of proceeds of current operations. In other words, the going concern need not liquidate its necessary business assets to pay off normal business obligations. Therefore, all the resources used, sold, or consumed in current operations are current resources and are realized in the period of the operating cycle.  

Current assets are those which will soon bring in cash or yield other benefits, within the next accounting period; they include cash, bank accounts, receivables, marketable securities, inventories, and prepaid items.

Current assets consist of cash and those assets which will be converted into cash during the regular operations of the organization. In addition to cash, current assets usually include receivables, merchandise, and prepayments of expenses.

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Many accountants hold the opinion that prepaid expenses which will become expense charges within a relatively short time (generally one year) should be classified as current assets. The argument is that while these items will not be converted into cash, they do represent items for which cash would have to be paid if possession had not already been obtained. Thus while they will not be converted into cash, their possession avoids expenditures which would otherwise be necessary. This view of classification . . . has received considerable support recently. On the other hand, at this writing there has been no marked tendency in practice to shift from the method of classification previously suggested.\(^{173}\)

**Intangible Assets**

The accounting treatment of intangible assets has presented many problems because by nature they seem to be questionable assets, whose value is not clearly evident. In Bulletin No. 24, the Committee on Accounting Procedure of the American Institute of Accountants sought to clarify the issues involved and suggest some definite standards for the two-fold program of accounting for intangibles. The two-fold problem may be expressed as follows: (1) What principle is to be used in recording an intangible asset when acquired; and (2) during various accounting periods, what disposition is to be made of the dollar amounts which have been assigned to the intangibles which have been assigned to the intangible asset? Bulletin No. 24 concerns only those intangibles which have been obtained as a result of a transaction with an outsider and not those which might have been developed by a

company through the regular course of business by research, experimentation, advertising, or otherwise.

The committee classifies intangibles into three groups:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration.

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

(c) The excess of a parent company's investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter's books at the date of acquisition, in so far as that excess would be treated as an intangible in consolidated financial statements of the parent and the subsidiary.174

At what amount should an intangible asset be recorded on the books? The position taken by the committee is very clear. Pointing out that the same principle should apply as that for tangible assets, the committee states that cost is the desired basis for recognizing intangibles in the accounts. There are circumstances in which "cost" is not readily ascertainable, for instance, when intangible assets are obtained as a result of an exchange of property of issuance of stock, or when both intangible and tangible assets are obtained in a lump-sum purchase with no separate cost price indicated for each group. In the first case, the viewpoint is taken that for non-cash transactions

cost may be determined either by the fair value of the consideration
given or by the fair value of the property acquired, whichever is the
more clearly evident. In the case of a lump-sum transaction, the
members of the committee urge that the aggregate cost should be allo-
cated between intangible and tangible property; furthermore, the
intangibles should be classified as to whether they should come under
class (a) or (b).

The disposition of amounts recorded as the cost of intangibles
which have a limited existence, either definitely known as a result
of law, regulation, or agreement, or assumed to be because of their
nature, seems to be fairly well settled in theory and practice. The
principle is that the cost of such intangibles should be amortized by
systematic charges in the income statement over the period benefited.

With respect to type (b) intangibles, or those which have no
present indication of limited existence or loss or value, the commit-
tee discussed two situations:

(3) The cost of type (b) intangibles may be car-
ried continuously unless and until it becomes
reasonably evident that the term of existence
of such intangibles has become limited, or that
they have become worthless. In the former event
the cost should be amortized by systematic
charges in the income statement over the estima-
ted remaining period of usefulness or, if such
charges would result in distortion of the income
statement, a partial write-down may be made by
a charge to earned surplus, and the balance of
the cost may be amortized over the remaining
period of usefulness.

(4) Where a corporation decides that a type (b)
intangible may not continue to have value during
the entire life of the enterprise, it may amor-
tize the cost of such intangible despite the
fact that there are no present indications of
such limited life which would require reclassification as type (a), and despite the fact that expenditures are being made to maintain its value. In such cases the cost may be amortized over a reasonable period of time, by systematic charges in the income statement. The procedure should be formally approved, preferably by action of the stockholders, and the facts should be fully disclosed in the financial statements. Such amortization is within the discretion of the corporation and is not to be regarded as obligatory.\textsuperscript{175}

Statements by Paton and Littleton concerning the proper handling of organization costs follow the trend of thought outlined above. They write:

Organization costs are sometimes viewed as intangibles on the ground that they are not readily assignable to specific tangible elements associated with the enterprise. As explained in a preceding chapter, proper organization costs are on just as good a footing as the costs of constructing plant and need not be regarded with suspicion. At this point it may be noted that general organization costs represent a permanent asset (not subject to amortization) so long as the enterprise maintains its status as a full-fledged going concern as reflected in earning power and tangible resources, but that such costs should be written off when a sustained contraction of income and tangible asset results from either unsuccessful operation or a process of liquidation. In other words, the general costs of organizing the business are not properly amortizable in the case of continuing, vigorous enterprise, but should not be retained intact in the case of a languishing concern.\textsuperscript{176}

\textsuperscript{175} Accounting Research Bulletin No. 24, "Accounting for Intangible Assets," December, 1944, American Institute of Accountants, p. 196.

\textsuperscript{176} W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 1940, American Accounting Association, p. 93.
A similar expression about intangibles in general is made by George C. May, who says:

The conclusion upon this whole question that seems to be indicated is that writing off intangibles is permissible but not mandatory. In the past, accountants have favored it solely on the grounds of conservatism. Regulatory bodies have, however, shown a disposition, while extolling conservatism, to treat actions founded solely thereon as if they implied recognition of a mandatory charge, and the exercise of conservatism may therefore be less prudent today than in the past...

There are no doubt some who regard intangible assets as unreal and favor writing them off on this account; but if once the view is accepted that value depends on expectations for the future, the proposal is either invalid or applicable almost equally to tangible assets. Indeed, experience shows that intangibles are often more enduring than tangible values.177

Authors of accounting textbooks seem to be divided in opinions as to whether intangible assets like goodwill, organization cost, and trade-marks, should be systematically written off the books. The following quotations represent a sample of expressions on this problem.

From the standpoint of accounting theory, the propriety of writing off organization expenses against periodic income cannot be questioned. It is in the application of theory to practice that difficulties arise. The amount of the periodic write-off, for example, may not be correct because the factors of time and consumption have not been established accurately. As a matter of fact, the discussion of the three preceding paragraphs actually does lend some support to the general practice of writing off organization expenses over a short period of time (i.e., three to five years or less).178

Since goodwill usually has no determinable duration of existence, it is not necessary to amortize its cost. However, goodwill is frequently written off against Earned Surplus within a few years of its acquisition. This amortization may be done regularly or at irregular intervals, according to the discretion of the board of directors.

Similarly, organization expense and other intangibles which do not have limited existence may be written off by charges against Earned Surplus. Such practice recognizes that all investment of funds for business purposes should be recovered in the business process if a profit is to be made, and in the absence of a determinable period for recovery, an arbitrary period is proper, particularly when recovery by sale seems remote if not entirely improbable.179

Organization expense represents a charge to the entire life span of a corporation and, since most corporations have a perpetual existence, the amount chargeable to any one year is not determinable. It may be carried on the books indefinitely, or it may be written off as a charge against Surplus.180

Some intangible fixed assets are not normally subject to amortization because they are assumed to have an unlimited useful life. Examples are trademarks, trade names, secret processes and formulas, and goodwill.

Such assets may be carried indefinitely at cost if there is no reason to believe that their useful lives will ever terminate. However, their amortization or complete write-off may be proper under several conditions. First, at the time of its acquisition there may be good reason to fear that the useful life of such an asset will terminate, even though there is no conclusive evidence to that effect; in such instances, periodical amortization charges may


be made against income. Second, at some date subsequent to acquisition, the asset may be found to be valueless, in which case its cost may be amortized over the estimated remaining life; or a portion of the cost may be charged to Earned Surplus (as representing amortization for prior periods), and the remainder may be amortized over the estimated remaining life.181

Valuation and Allied Problems

Another problem in connection with asset accounting is the determination of what is the cost of an asset. The American Accounting Institute and American Accounting Association take similar positions with respect to bases for measuring the original cost of an asset. According to the standards which have been established the measure of asset cost when purchased may be the cash outlay, the fair market value of any noncash consideration, or the fair market value of the asset acquired if the other two measures cannot be used. The AAA statement on this concept follows:

The importance of costs as a record of the accountability of an enterprise for its resources makes it essential that their determination be based on available objective evidence. When an asset is purchased such evidence is found in the cash outlay, in the fair market value of any noncash consideration, or, in the absence of these measures of cost, in the fair market value of the asset acquired. The measure of cost for an asset received through a revenue transaction is fair market value, ordinarily indicated by the established selling price of the goods or services sold. Where an asset is acquired from investors or donors its cost for accounting purposes is fair market value at the time of acquisition.

The cost of a group of assets acquired for a lump sum should be allocated to property units, tangible or intangible, after careful consideration of the nature and condition of each unit, and its intended use and prospective earning power or value in exchange.182

In general, discussions appearing in college textbooks with respect to the valuation of assets followed the AAA and the AIA statements on the issue. Below are typical presentations:

In cases of pronounced unequal bargaining power between buyer and seller, a purchaser may acquire fixed assets at a price substantially less than the intrinsic values of the assets. . . The accounting problem at issue is whether to set up the asset at the higher fair market value or at the lower purchase cost. Orthodox accounting adheres to purchase cost, although considerable merit lies in recording the asset at the fair market value, especially where the fair market value and cost amounts are appreciably divergent. The accounting procedure based on the use of the higher fair value must recognize that gain cannot be derived from purchase and that therefore the excess of fair market value over purchase cost cannot be credited to income account.183

If an asset is acquired at a cost, the cost is the measure of accountability; if an asset is acquired by gift, there is still an accountability, the amount which seems to be properly measured by the fair value of the property.184

The cost of a plant item ordinarily includes all out-lays up to the time it is usable for the purpose for which it was acquired. All costs incident to purchase, transportation, installation, and preliminary experimentation

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are added to the purchase price in obtaining the total investment in the asset. This total investment is then charged to the operating periods that receive the benefits arising from the investment.¹⁸⁵

Once fixed assets have been recorded in the books, there is another problem which develops around subsequent expenditures thereon. This important phase of accounting, which may play a significant influence on the determination of net income, is the necessity of distinguishing between capital and revenue charges. When an expenditure is made on a fixed asset item of a nature which will benefit not only the current but subsequent periods, it is called a capital expenditure, the amount of which should be added to the fixed asset account and systematically distributed over the periods benefiting therefrom. On the other hand, an expenditure that is related to current operations only is termed a revenue charge and should be considered an expense of the current period. In many cases, this distinction is clear cut and easy to make, but in others it becomes very difficult to decide whether items should be capitalized or not. Very often, it becomes a matter of individual judgment, which accordingly lends to variations in practice. Frequently, materiality plays a part in the final decision-making. The importance of exercising a high judgment in this area is pointed out by Karrenbrock and Simons:

Income cannot be accurately measured unless expenditures relating to plant assets are properly identified as capital or revenue. When an expenditure is recorded as a revenue


Materials Used in the Study

As a basis for the study, the writer has analyzed 20 college textbooks which are representative of those used in elementary, intermediate and advanced classes in general financial accounting in leading colleges and universities throughout the country. Besides their academic attainments, many of the authors are also known for their contributions to professional magazines and have held important positions with national and local accounting organizations. The textbooks used for this study have been limited to those published since 1946, the year World War II ended, the belief being that efforts would have been made to bring them up-to-date and incorporate changes in procedures and philosophies growing out of the immediate pre— and post-war developments.

The contemporary literature, with which the textbooks have been compared, consists primarily of monographs and other publications of the American Institute of Accountants, the American Accounting Association,
charge, the entire expenditure is disposed of in a current period; when it is recorded as a capital charge, the expenditure is charged to the income of future periods through recognition of regular charges for depreciation. An incorrect charge to an asset instead of to expense results in a current overstatement of assets as well as current profit and in the subsequent understatement of profits when depreciation is recognized. Conversely, an incorrect charge to expense instead of to an asset results in a current understatement of assets and current profit and the subsequent overstatement of profit in the absence of appropriate charges for depreciation.\textsuperscript{186}

Johnson makes a similar statement:

If an expenditure is capitalized instead of being charged to expense, the profits of the business for the period are overstated, as are also the assets and net worth. On the other hand, if expenditures are charged to expense instead of being capitalized, the profits are understated as are also the assets and net worth. Financial statements will therefore be seriously in error when the accounting for property expenditures has not been correct. When there is doubt as to the correct placement of an expenditure, it is conservative practice to charge the expenditure to expense.

Many companies follow a policy of refusing to capitalize an expenditure amounting to less than a minimum figure, say $25.00, $50.00, or $100.00. Larger amounts are carefully analyzed. Practical considerations indicate that a conservative policy of this kind has much to recommend it.\textsuperscript{187}


Chapter IX
LIABILITIES, CAPITAL STOCK, AND OTHER PROPRIETORSHIP ITEMS

Accounting for liabilities involves a consideration of such issues as the nature of liabilities, their classification, measurement, and special problems. The special problems, for the most part, center around the accounting treatment of situations growing out of long-term liabilities, such as differences between the face amount of obligations and funds received, refunding operations, and satisfaction of the liabilities for less than the carrying values.

It appears that there are not as many differences of opinion among accountants in accounting for liabilities as in the case of some of the other items. This viewpoint is expressed by Ascher:

> Although the amounts of liabilities may sometimes be larger and the scope of the problems encountered may be broad, the amount of difference between alternative methods of liability accounting as a rule will be small. The large discrepancies or variations which arise in accounting usually appear outside the liability field.188

The following statement by Karrenbrock and Simons is illustrative of what authors of textbooks say about the general nature of liabilities:

> All obligations must be shown on the balance sheet and properly classified as current or non-current. The problem of measurement or valuation does not arise in the case of most

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liabilities. However, in those instances where amounts are not definitely determinable on the balance sheet date, estimates will have to be made as accurately as possible. Where liabilities may reasonably materialize as a result of certain past acts or present conditions, such contingent claims should be recognized either by a position on the balance sheet or mention in footnotes.189

The opinions of members of the Committee on Accounting Concepts and Standards of the American Accounting Association with respect to the nature of liabilities are summarized in their 1948 statement as follows:

Liabilities are claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources. They are measured by cash received, by the established price of noncash assets or services received, or by estimates of a definitive character when the amount owing cannot be measured more precisely.190

Sanders, Hatfield, and Moore emphasize the two-fold nature of the problem of accounting for liabilities.

The first problem is to assure the inclusion of all liabilities, and the second is to classify them under proper descriptive titles. Little question is raised as to the amount at which liabilities are to be listed in the balance-sheet, as in the great majority of cases they appear at their face or par value. There may be occasion, however, to estimate the amounts of some liabilities of an indeterminate or contingent character.191


Liabilities are usually classified into current and fixed, with the date of maturity, whether within or beyond a year, being the main distinction. Present practice with respect to the accounting treatment of current liabilities is summarized in Accounting Research Bulletin No. 30. In that bulletin the committee states:

The term current liabilities is used principally to identify and designate debts or obligations, the liquidation or payment of which is reasonably expected to require the use of existing resources properly classifiable as current assets or the creation of other current liabilities. As a balance-sheet category, the classification is intended to include obligations for items which have entered into the operating cycle, as in the case of payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale, collections received in advance of the delivery of goods or performance of services, and debts which arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, or royalties. Other liabilities the regular and ordinary liquidation of which is expected to occur within a relatively short period of time, usually twelve months, are also intended for inclusion, such as short-term debts arising from the acquisition of capital assets, serial maturities of long-term obligations, and agency obligations arising from the collection or acceptance of cash or other assets for the account of a third party. Income taxes should be included as current liabilities even though the entire amount may not be payable within twelve months.192

It is standard procedure to value liabilities at the face amounts payable at maturity, although this represents a slight variation from the most precise valuation according to the mathematical principles

concerning present values. This concept which serves as the foundation for many of the applications of annuity computations is that the right to receive a sum of money at a future date has a present value smaller than the maturity value. Ascher presents the following discussion of the issue:

The present value of $1,000 due two months hence, for instance, may be estimated at $999. If a creditor or a banker considers that the present value of a promise to pay $1,000 two months hence is only $990, why should not the debtor likewise figure that the $1,000 he owes at that future date amounts to the smaller sum now? . . .

This logic applies to all claims and debts payable in the future, and, except in the rare case of negative interest, in which the creditor pays a premium to receive a future sum, a present value is always less than a future value. Therefore a liability always has a present value less than its maturity value. . .

While good accounting practice might be expected to record all liabilities at their present instead of their face values, in line with the logic set forth above, certain concessions to expediency have been made by accountants, with the result that practice in the treatment of liabilities varies. Many firms take the realistic position that the amounts involved are not worth the extra worth and record liabilities at their face value. Other enterprises, usually financial institutions, are quite meticulous in figuring the present value of liabilities to pay in the future.193

Long-Term Debt

By and large, the most difficult problems which have arisen in the area of liability accounting have been those in connection with long-term liabilities. As a source of permanent enterprise capital, long-term debts involve much more than a consideration of paying them off when due. On the other hand, numerous problems develop in connection with such matters as the issuance of bonds at or below par, the amortization of discounts and premiums, the retirement, and the refunding of bond issues. As May puts it:

Nothing better illustrates what has been called the cohesiveness of accounting than the fact that many of the considerations which arise in the accounting for fixed property are found to have a bearing, also, on the accounting for long-term borrowings. This fact is not always immediately recognized because, particularly in American thought, discussion of such borrowing is apt to center on their character as debt. But this characteristic, although the simplest, and most obvious, offers only a minor problem in the performance of the recording function of accounting. From the standpoint of theory, and of the relation of accounting to the economy, it is more significant that an issue of bonds provides capital than that it creates debt; and as a long-term contract for the use of money it presents even more important and interesting problems.194

May summarizes the problems facing accountants in this area in the following:

Important questions in American accounting for long-term borrowings arise from three causes: First, there is frequently a difference between

the sum borrowed and the sum required to be
paid at maturity; in other words, bonds are
issued at a discount or, less frequently, at
a premium. Secondly, changes in current in-
terest rates may result in borrowing contracts
becoming highly disadvantageous, so that re-
funding is undertaken. Thirdly, an impairment
of the value of enterprises may make possible
redemption of debt at large discounts.195

When bonds are issued for an amount which is more than face
value, the difference between face value and amount received is
called a premium. Likewise, a discount is recorded when the funds
received by the issuing corporation are less than the face amount of
the debt. The first problem which has been created by such a situa-
tion is to make a decision as to how the premium or discount will
appear in the balance sheet of the issuing corporation. For many
years, it has been the practice to include a discount on bonds payable
under the "deferred charges" classification on the asset side of the
balance-sheet. Similarly, a premium on bonds payable would appear on
the liability side as a "deferred credit." In recent years, several
writers have stimulated lively discussion by urging that both discounts
and premiums be presented in the same section with the related obli-
gation as an addition or subtraction therefrom. Among those who
advocate this treatment are Paton and Littleton, who write:

Unaccumulated bond discount cannot express a
loss, for there is no dissipation of an asset
previously acquired; it cannot express an asset,
for no expenditure has been made which would
consider an addition to property in that
amount. The inescapable conclusion is that

discount on bonds issued is a debit representing prospective interest payable at maturity, and as such should be reported in the balance sheet as a contract to the face or maturity amount of the indebtedness rather than as an asset. It is especially unfortunate to apply the expression "prepaid interest" to unaccumulated discount. Far from being prepaid, the discount is unpaid interest, that portion of the total interest which will not be paid until the date the bond is due.

To the "practical" objection that in the event of receivership or liquidation of the enterprise prior to the date of bond maturity the par amount becomes the actual legal liability, it need only be said that the standard of measurement proposed conforms strictly to the basic concept of the going concern, the concept of continuity. For the insolvent enterprise, in the process of liquidation or reorganization, another standard may be required. It may be added that any legal rule which calls for the ignoring of unaccumulated discount in liquidation proceedings is evidently not based on considerations of equity.196

May makes the following comment on the presentation of a long-term liability:

Some accountants argue that just as accounting for assets is conducted on the basis of cost, so only the amount received by way of loan should be recorded on the books of account when the loan is made, and that the par value should appear merely in an explanatory note on the balance sheet. The existing practice is, however, so well established that today more inconvenience than advantage would result from the adoption of these views, even if there were general acceptance of them within the profession, which there certainly is not.197


Opinion among textbook writers, upon the basis of this study, seems to be about evenly divided concerning the proper presentation of discounts or premiums on bonds payable. The following are typical comments of those who adhere to the traditional presentation:

Discount on bonds is listed in the Deferred Charges section of a balance sheet, and premium on bonds is listed in the Deferred Credits section thereof. Unlike prepaid expenses, discount on bonds may not be included with current assets, since it is not an expense which, if not prepaid, would require the use of current assets during the current operating cycle.\(^\text{198}\)

It has long been regarded as correct accounting procedure to show unamortized bond discount on the asset side of the balance sheet under the Deferred Charges caption, and unamortized bond premium on the liability side under the caption of Deferred Credits. . . Recently there has been some agitation in favor of showing unamortized discount as a deduction from the par of the bonds. . . This procedure has not been generally adopted by the accounting profession.\(^\text{199}\)

When a corporation issues bonds at a discount it incurs a liability to pay back more than it receives. This difference will, over the life of the bonds, be written off as a charge to interest expense. It may therefore be set up as a deferred charge on the balance sheet. Some accountants object to showing bond discount as an asset under the deferred charge heading. They argue that it is not interest paid in advance since the amount of the discount will not actually be paid to the bondholders until the maturity of the bonds. They suggest that the discount be shown as a deduction from bonds payable. . . Either of the above methods may be employed. Illustrations and problems in this text will show bond discount as a deferred charge.\(^\text{200}\)


Among the discussions by those authors who recommend the other procedure are:

By classifying Bond Discount as a contra account to the Bond Payable account, the value of the liability is properly stated on the books.

Applying the same reasoning to bond premium leads to the classification of that credit balance as a liability additional to the bonds payable liability.201

Since bond discount and bond premium are simply adjustments to the price of the bonds, the logical way to show them on the balance sheet is as a deduction from or an addition to the face value of the bonds at maturity.202

The Discount on Debenture Bonds account is often treated as prepaid interest and shown as a long-term deferred charge among the assets on the balance sheet, but, as in the case of discount on notes payable, there is in fact no prepayment of interest. . . Since it is in reality, an adjustment of the amount of the obligation, the discount could be better shown on the balance sheet as a deduction from the liability account Debenture Bonds Payable.203

Once a bond premium or discount is recorded on the books there seems to be a unanimity of opinion among leading accounting writers on what disposition should be made with the amount in the periodic determination of income. The present practice is to systematically amortize the discount or premium over the total period in which the


the National Association of Cost Accountants, and other professional
organizations. In addition, material which has been published in connec-
tion with special research projects in the field of accounting or related
fields, has been utilized. With only a few exceptions, the study has
been restricted to a consideration of literature appearing since 1939,
the date when the American Institute of Accountants first began to issue
its Accounting Research Bulletins.
bond issue is outstanding by means of an adjustment of the amount
recorded as an interest charge in each fiscal period. That such
general agreement has not always existed is brought out by the com-
mittee on accounting procedure of the AIA in tracing the history of
the techniques adopted in handling such discounts or premiums. They
report as follows:

Until the early days of the century, it was
common to regard such discount as being a capi-
tal charge; and when the unsoundness of this
treatment was recognized, alternative methods
of treatment became accepted, under one of
which the discount was distributed over the
term of the issue, and under the other, the
discount was charged immediately against sur-
plus, the latter being regarded generally as
the preferable course. Even today, the Inter-
state Commerce Commission grants an option to
railroads under its jurisdiction to charge bond
discount to profit and loss (surplus) when the
bonds are issued, or to anticipate by an appro-
priation from profit and loss the amortization
of such charges through income in later years
(Accounting Classification rev. to January 1,
1936, pages 191 and 197).

This committee is of the opinion that the
treatment of such discounts as a part of the
cost of borrowed money in the annual income
account of the company to be distributed system-
atically over the term of the issue is the
sound accounting procedure, and it believes
that this view is shared by the overwhelming
majority of present-day accounting authorities.
The anticipation of this income charge by a
debit to income of a previous year or to sur-
plus has in principle little more justification
than would a corresponding treatment of coupons
due in future years.204

204 Accounting Research Bulletin No. 2, "Unamortized Discount and
The AAA statement on the periodic accounting for bond discount or premium is similar:

Any difference between the amount payable when a liability is settled and the amount of the cash or its equivalent received when the liability is incurred should be accumulated or amortized systematically during the period the obligation is outstanding.205

As has been indicated, there is virtually complete agreement among leading accountants that a discount or premium on bonds should be spread over a period of years by systematic write-offs; the method of calculating the amount of the annual write-off presents a more difficult problem. The policy adopted in the majority of cases is to accomplish the amortization on a straight-line basis, that is in equal installments over the period of years in which the debt is outstanding. However, most accounting writers indicate that this is not the most scientific method. On this matter Paton comments as follows:

The straight-line plan of accumulating discount or amortizing premium has the support of the Internal Revenue Code and has been widely commended on the score of simplicity. The interest method is much more acceptable, however, particularly for the issuing corporation. Straight-line absorption of discount or premium results in equal periodic charges to income on account of interest, despite the increasing equity of the bondholder in the case of a discounted security and the decreasing equity where the security was issued at a premium. Under the interest method the interest charge each period is in harmony with the amount of the effective liability for the period—a condition clearly desirable. This

point is especially important where the amount of discount or premium is relatively large; where the amount is small the distortion resulting from straight-line procedure is not very serious.206

In his discussion of methods of amortization, Mauriello points out why the straight-line method is the most widely employed one. He says:

Of the two methods of amortization, the scientific method is more accurate. A bond is purchased by an investor to yield the same rate of return over its entire life. The scientific method reflects this desired result, whereas the straight-line method erroneously shows an increasing rate of return for bonds purchased at a premium. Nevertheless, in practice the straight-line method is the method extensively employed, for two reasons: (1) the additional clerical work under the scientific method is generally excessive in relation to the magnitude of the error involved; and (2) the bonds purchased as investments may be disposed of periodically, and thus nullify any accounting refinements based on an expected holding of the bonds until maturity or the earlier call date.207

The final issue in accounting for long-term liabilities, under consideration here, is centered around problems created by refunding or other types of similar operations in which a corporation may replace one debt with another issue of bonds. Because of serious differences of opinion among accountants concerning this problem, the committee on accounting procedure issued Bulletin No. 2, in which were


presented three methods of disposing of the unamortized discount balance and premium in cases where bonds are retired by the issuance of new bonds. These methods are: (1) a direct charge to earned surplus; (2) amortization over the remainder of the original life of the issue retired; or (3) amortization over the life of the new issue. One of the first questions taken up in this bulletin is whether a bond discount and any premium paid on the redemption of bonds should be dealt with separately or as one. According to the committee, "the conclusion is that the unamortized discount and redemption premium should be dealt with as one." In its conclusions about how such amounts should be handled in the accounts the committee indicated its approval of the first two methods mentioned above.

In order to best understand the tenor of the committee's thinking on the various issues involved, the summary opinion of the group is presented below:

1. The first alternative, writing off the amount to earned surplus when the refunding takes place, conforms more closely than any other to hitherto accepted accounting doctrines and has the support of a decision of the Supreme Court and the approval of many regulatory bodies.

In the opinion of the committee it is clearly a permissible method, and there is no occasion for qualification of the report in cases in which it is employed. At the same time, this method is open to the objection that while conservative with respect to the balance-sheet, it tends to produce an understatement of income charges for the cost of borrowing. The committee attached

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weight to this objection, especially in view of the growing recognition of the importance of the income account as compared with the balance-sheet. As a general principle, the committee favors the absorption of charges in the income account and a corresponding limitation of charges to earned surplus.

If the debt is finally discharged—otherwise than by refunding—prior to the original maturity date of the issue, any balance of discount and redemption premium then remaining on the books should be written off at the date of such retirement.

2. The second alternative, distributing the charge over the original life of the bonds refunded, has in the opinion of the committee considerable support in accounting theory and has the great merit that it results in the reflection of the expense as a direct charge under the appropriate head in a series of income accounts.

The committee is clear that this method should be regarded as permissible, and expresses the further opinion that it perhaps conforms more closely than either of the other methods to the current trend of development of accounting opinion.

The committee is not prepared at this time to express a preference for this method so definite as to call for qualification of the certificate if any other method is employed, but proposes to reconsider this aspect of the question as a part of a study to be undertaken of the general question of charges to earned surplus.

3. The third alternative, amortization over the life of the new issue, does not seem to be adequately supported by accounting theory, but to run counter to generally accepted accounting rules. It does not seem to possess any marked practical advantages in comparison with the second alternative of amortization over the life of the old issue, which finds far better support in accounting theory—on the contrary, it seems to the committee to exaggerate the annual saving from refinancing, and therefore may tend to encourage transactions which are not, when
properly viewed, advantageous. Although this method has in the past been freely permitted by regulatory bodies, the committee believes that it should not be regarded by the profession as an acceptable method for the future. It must, of course, be permissible for corporations to adopt it in cases where it has been prescribed or authorized by regulatory bodies to which they are subject. The committee believes that in any other cases in which this method is employed an accountant should make an exception in respect of such treatment from any certification that accounts conform to accepted accounting principles.

4. The committee is further of the opinion that, if an unamortized discount and redemption premium are carried forward after refunding, it should be regarded as permissible to accelerate the amortisation of the amount as long as the charge is made against income and is not in any year so large as seriously to distort the income figure for that year.

Whatever method is employed, it should be clearly disclosed, and if the unamortized discount and redemption premium on refunding are carried forward, the amount of the annual charge should, if significant in amount, be shown separately from other charges for amortization of bond discount and expense.209

Paton and Littleton take the position that the proper procedure is to follow method 1 (above), as is indicated by the following excerpts from their discussion of the matter:

. . . No cost factor of any kind should be held on the books as a charge to future revenue when there is decisive objective evidence of the termination of significance. Bond-issue costs, for example, must be amortized during the life of the contract to which they attach; if for any reason the contract is terminated earlier than was originally planned the unamortized balance of the

issue cost should be written off. It is sometimes argued that in the case of a refunding operation the balance of the issue cost attaching to the security retired may be fused with the cost of emitting the new security and by this route absorbed in future revenue charged. This position is objectionable. In making the decision to refund, as in making a decision to substitute improved plant for old, all pertinent factors should be carefully considered. Once the decision has been reached, however, there is scant justification for carrying forward costs attaching to a closed contract; to do so would inflate the cost of securing funds just as the carrying forward of a part of the cost of retired plant would overstate the amount invested in the existing layout of facilities.

In retiring bonds or other contractual securities prior to maturity date a premium is usually paid. If the security was issued at par or maturity value the amount of the premium over par measures the special loss incurred; if it was issued at more or less than par the difference between the call or redemption price and the amortized or accumulated amount of the liability to date of retirement measures the loss suffered (or is an adjustment of maturity amount to the true cost of the liability, and any balance of premium or discount remaining at the date when the contract is closed should be absorbed at that point.210

A number of textbooks have discussions of the three methods of handling unamortized discounts and premiums and redemption premiums in the accounts, pointing out the standard arguments in favor of each method. Some authors exhibit a tendency to favor the immediate write-off of the items under consideration at the time of the refunding operations. In support of this, Mauriello says:

210 W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 1940, American Accounting Association, p. 95.
The theory of a closed transaction is considered by the author as a more logical one than that of an amended transaction. The contention under this latter theory that the loss from the refunding operation should be postponed for purposes of offsetting the future savings in interest has no parallel in accounting. The unamortized discount on the old bonds would have been written off to expense in the course of operations even if the bonds had not been refunded. The refunding merely accelerates the write-off. The discount on the old bonds, furthermore, presumes a continuing payment of nominal interest over the life of such bonds. When the nominal interest ceases the related discount should also disappear.211

Likewise, Karrenbrock and Simons describe the above method as the most conservative:

If the most conservative approach is to be taken in accounting for the refunding operation, bond discount and call premium on the old issue would be considered costs of terminating the old contract.212

However, as was stated above, most authors merely discussed the different procedures without taking sides.

Contingent Liabilities

Contingent liabilities are described as liabilities which might develop as a result of certain past activities or current conditions. The accounting problem in connection with this class of liabilities is centered around the balance sheet presentation on a date at which no legal claim exists. Sanders, Hatfield and Moore state that:


It is a matter for nice judgment to determine when a contingency becomes sufficiently threatening to require entry in the balance-sheet proper. Moreover, a company is not called upon to publish a specific amount of liability if by so doing it would prejudice its own position in controversy.213

The following quotation summarizes present-day practice with regard to contingent liabilities:

While at the date of the balance sheet there is no legal liability, some reference must be made to the possibility of such claims materializing in the future if the company's financial condition is to be fully shown. . .

Among the contingent liabilities that require recognition on the balance sheet may be included those arising in connection with the discounting of customers' notes and accounts, taxes and other charges in dispute, merchandise and equipment purchase commitments, contingency and cancellation clauses in leases and other contracts, pending lawsuits, and accommodation endorsements.

The contingent liability is generally reported on the balance sheet by means of (1) a parenthetical remark, (2) a footnote, or (3) a description under a special contingent liabilities heading.214

Capital Stock, and Other Proprietorship Items

Several of the major issues relative to the proprietorship items have already been discussed in this study in connection with the term "surplus," "reserves," and certain questions involved in the determination of periodic income. However, a few of the problems in this area

are so important that they deserve separate consideration. May calls attention to the fact that:

This area of accounting is one in which the lawyer, the economist, and the accountant all feel that they have a point of view and a terminology which demand recognition; and few accountants would regard present accounting procedures within it as satisfactory. These procedures suffer from conflicts of laws and legal concepts; from legal fictions, and from legal devices which, if convenient for business purposes are out of harmony with accounting and economic ideas. They are affected also by the conflict between value and cost as basic accounting concepts and by uncertainties of valuation.\(^{215}\)

Pointing out types of variations in accounting thought concerning the proprietorship section, May continues:

Since accounting is now recognized as utilitarian, writers are apt to postulate rather than demonstrate a usefulness and advance from that point to the conclusion which they favor. One group proceeds from the assumption that usefulness calls for a careful segregation of values paid in from values created by operations and not distributed. Another finds usefulness in differentiating between amounts legally divisible and those not distributable except in dissolution. A third group regards segregation of contributions by individual classes of stockholders as indispensable. Still another holds that here, as elsewhere, matching transactions in an appropriate manner is the essence of sound accounting, and insists that the choice of transactions to be matched against one another should be based on realities.\(^{216}\)


The failure of a large number of persons to understand the basic assumptions serving as the framework for accounting methods has undoubtedly been the cause of adverse criticism. The limitations inherent in accounting are not widely appreciated. A review of contemporary literature reveals that several writers place emphasis on the conventional character of many accounting procedures. It appears that authors of textbooks could well adopt the policy of setting forth very clearly the basic assumptions of accounting. Students then could better understand the theories and procedures which are presented in the classroom.

The business entity is one of the conventions which serves as a starting point for the development of accounting concepts and standards. On this matter Gilman makes the following comment:

The entity convention asserts that the unit for which double entry records are kept is an artificial person having possession of or 'owning' certain assets contributed, in one form or another, to it by others who are, therefore, its creditors.

Disregarding legal objections—and this is most important for proper understanding of the entity convention—those who advance funds or the equivalent of funds to an accounting entity are its creditors and, in so far, as double entry bookkeeping is concerned, it is unimportant whether, as in the case of lenders or vendors, they consider themselves as outsiders,
It is noticeable that such terms as "capital stock," "earned surplus," and "capital-surplus," are absent from the concepts expressed by the AAA committee under the heading "Stockholders' Interest," in their 1948 Statement:

Stockholders' interest is the investment of the owners in the enterprise, consisting of paid-in capital and retained income.

(1) Paid-in capital is measured by the cash, or the fair market value of other assets or services, contributed by stockholders or by persons acting in a capacity other than that of stockholders or creditors, or by the amount of liabilities discharged upon the transfer of an equity from a creditor to a stockholder status. Paid-in capital may be reduced by the redemption or other reduction of outstanding shares, payments of liquidating dividends, or adjustments effected by a corporate reorganization. The reduction of paid-in capital upon the contraction of outstanding shares may not exceed the prorata position of paid-in capital applicable to the number of shares contracted.

(2) Retained income is the amount of income since the formation or a reorganization to the enterprise less the amount distributed to stockholders. Distributions include dividends and the excess of the amount of assets disbursed in the reconversion of shares of capital stock over the prorata portion of paid-in capital applicable to such shares. The distinction between paid-in capital and retained income should be permanent. Where retained income has been designated as paid-in capital by means of stock dividends, recapitalizations, or by other customary corporate action the amount so designated should be indicated in the balance sheet.217

Accounting problems in connection with stock dividends attracted the attention of the AIA committee on accounting procedure, resulting in the issuance of a bulletin on the subject in 1941. In this bulletin, however, many of the proposals and conclusions reached by the committee appear to be more in the area of managerial decisions rather than accounting policy. From the standpoint of the issuing corporation, the committee recommends that the amount of the stock dividend, where regularly recurring, not exceed the amount of current income. Their statement is given below:

While the aggregate amount of earned surplus to be capitalized by the stock dividend, as distinguished from the number of shares to be issued, is within the discretion of the board of directors, proper corporate policy requires that in the case of regularly recurring stock dividends, the amount of earned surplus capitalized should not exceed the amount of current income, since such dividends are likely to be interpreted by the stockholders as notice that the corporation has current income which it is not desirable or practical to distribute as cash dividends.218

In another section of this bulletin the committee sets forth recommendations concerning the number of shares to be issued in the case of a stock dividend. Some accountants believe that this is not a matter of accounting policy. The committee writes:

Proper accounting and corporate policy also require that the amount of income capitalized per share bear an appropriate relationship to the existing capitalization per share. Accountants now generally regard the capital-stock and the capital-surplus accounts as being in essentially the same category, i.e., capital, despite the

fact that they are reported separately for legal and accounting purposes. The amount per share in the capital-stock and capital-surplus combined, before the issuance of the stock dividend, should be maintained upon its issuance by capitalization of at least a like amount of earned surplus for each dividend share. The number of dividend shares should therefore not exceed the number determined by dividing the amount of earned surplus authorized to be capitalized by the total amount per share in the capital and capital-surplus accounts before the declaration of the stock dividend. The foregoing computation may be adjusted by the elimination from such capital surplus of any portion thereof not forming part of the book value of the common stock.

In addition to meeting the foregoing requirement the directors, in their study as to the number of shares to be distributed as a stock dividend, should take into consideration a fair market value per share for the increased number of shares to be outstanding after the stock dividend, and where such fair market value per share is substantially in excess of the amount per share of the combined capital-stock and capital-surplus accounts before the stock dividend, they should fix the number of dividend shares so that the amounts charged to earned surplus per share will have a reasonable relationship to such fair market value. Unless such relationship is maintained, the stockholder may believe that the market value of the dividend shares he receives represents his pro-rata share of the capitalized current income of the corporation, whereas the market value per share may be materially in excess of such capitalized income per share.219

The practice by corporation of reacquiring some of their shares by purchase, or otherwise, has also prompted considerable discussion in accounting circles. One school of thought has held that such

"treasury stock," when the corporation contemplates reissuance, may be treated as an asset in the balance sheet. The second school indicates that the correct treatment is to consider the par value of reacquired shares as a deduction from capital stock. This is the viewpoint supported by Paton and Littleton, who states:

The treatment of reacquired shares should be consistent with their nature as capital. If the shares are reissuable the amount paid therefor should be regarded as an unallocated reduction of capital and surplus rather than as an asset. If the shares are not reissuable, or if they take on the status of unissued or retired shares, the amount paid should be charged to capital stock account up to the amount originally credited therein; any balance remaining should be charged to paid-in surplus up to an amount not in excess of the pro-rata portion of paid-in surplus applicable to the shares in question; any part of the total payment which cannot be thus absorbed should be charged to earned surplus. Any gain derived from retiring shares, being in the nature of a contribution to capital in the form of a donation or forgiven debt, should be credited to paid-in surplus.220

There was complete agreement among textbook authors that a sharp distinction should be made between contributed and earned capital. This concept was embodied in all of their discussions of the proprietorship sections of corporations.

Concerning the accounting procedures for stock dividends, the recommendations of the AIA committee with respect to the amount of retained income to be capitalized have not been followed to a great

extent. Mauriello, however, gives support to the suggestion of the committee in the following words:

Contributed or paid-in capital represents the investment of stockholders which from an economic standpoint should be retained intact in the business, both in the aggregate and per share. This contributed or paid-in capital is reflected on the books of the corporation in the Capital Stock and Paid-in Surplus accounts. Accordingly, in recording a stock dividend, the objective should be to prevent a dilution of the value per share of stock based on the sum of the Capital Stock and paid-in Surplus accounts.

To maintain the book value per share of contributed capital, such book value immediately preceding declaration of the stock dividend should be ascertained and multiplied by the number of dividend shares to be issued. The resulting amount establishes the charge to the Earned Surplus. \(^{221}\)

Tunick and Saxe also illustrate procedures which incorporate the recommendations of Bulletin 11. \(^{222}\)

The authors are harmonious in their opinion with regard to the balance sheet position of reacquired shares, or treasury stock, which is in agreement with the AIA position that they are not an asset and should be shown as a deduction from capital stock. Some of their comments are presented below:

Treasury stock should not be shown on the balance sheet as an asset. This is often done in practice, but there is little justification for it. . . . To the argument that treasury stock may be easily converted into cash as any other current asset, the answer may be made that the same may be true.


of unissued stock and it has long been agreed that unissued stock is not an asset.223

Treasury stock should never be shown as an asset in the balance sheet. This classification would overstate the total of assets and misrepresent the amount of outstanding capital stock.

Treasury stock does not conform to the definition of an asset, i.e., anything of value owned. Treasury stock is not an asset even though cash or some other asset has been expended in its acquisition. The effect of this kind of transaction is not the acquisition of an asset but the reduction of net worth. Intention to reissue or not to reissue the stock does not alter the effect of the transaction.224

It is sometimes suggested that since treasury stock may be resold it has asset characteristics, but this, nevertheless, does not make it an asset. What actually occurs with the acquisition of treasury stock is a reduction in the obligation of the organization to its owners.225


That the preparation of financial statements constitutes one of the most important phases of an accountant's task is embodied in the definition of accounting by the American Institute of Accountants. That body defines accounting as:

The art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof.\(^{226}\)

In performing the task of summarizing and interpreting the accountant makes use of a variety of statements. This is particularly true in the case of information summarized and presented to management for its use in the day-to-day operations of an enterprise. However, it is in the area of conveying information to outsiders—investors, government, the public, and other interested groups—that the accountant assumes a tremendous social responsibility. Accordingly, it is in this area that certain accounting theories have developed.

Mention has already been made of the importance of financial statements, principally balance sheets and income statements, in

serving as a report of stewardship on the part of management to a large number of absentee-owners. It is to be expected then that a knowledge of the significance of their responsibility in the preparation of accounting statements has led accountants to give much time and effort to the development of the most acceptable and useful standards of reporting. Accounting theory and practice with regard to the preparation of accounting statements center around such problems as the descriptions of items, the classification of items, and the form of statements. Throughout contemporary literature on the subject of accounting statements runs a central theme of the doctrine of full disclosure, discussed in another chapter.

In accordance with the introductory remarks above, the principal emphasis in this chapter will be on statements for outsiders, with most attention being given to the income statement and the balance sheet.

The Income Statement

Several times throughout this study it has been pointed out that the income statement has assumed top place as the most significant accounting report. The final figure of "net income" which appears on published statements of corporations is subject to a great deal of analysis and study by many segments of our population—investors, economists, labor groups, governmental agencies—and that many other groups or individuals.

In an article on "The Increasing Significance of the Income Statement," Bailey points out five tests or criteria which might serve as
guides to development in the area of financial reporting. He describes the five tests as:

. . . The usefulness to the "non-incider;" responsibility for clearly showing net income; improving the service of income statements as a guide to the efficiency of a business and the basis for a judgment as to what may be expected for the future; relationship of income statements to the economic conditions of the year for which they are presented; and reduction of areas of variety of practice through additional criteria.227

Despite the general reliance on financial statements as indices to the fortunes of business concerns, several writers have repeatedly pointed out their limitations and the necessity to take into consideration other factors which neither appear in the statements nor the books of account when judging the future possibilities of an enterprise. On this matter May states:

In any case, those who rely on financial statements should realize that computations of past income are based on present knowledge that is often imperfect and on implicit assumptions as to the course of events in the future. They are not statements of fact but are conclusions that result from applying a body of conventions to the events and transactions during the period they cover. They cannot be safely used as a guide to action by any who have not at least a reasonable understanding of their nature. Moreover, such statements are in part a reflection of the temperament and modes of thought of those responsible for their presentation, and no rules can change this fact.228


May also points out that it may be asking accountants to assume too great a task to attempt to prepare statements which are most suitable for all interested parties. His comment is as follows:

Admittedly, any current determination of corporate income for a year, or shorter period, is at best an approximation; but the further question—an approximation to what?—would be answered somewhat differently by different classes of persons, such as executives, investors, stock speculators, financial statisticians or investment counselors, bank creditors or bondholders, economists, accounting theorists, etc. No account will serve equally well the purposes of each of these classes, so that the practical question to be faced is how far the form is to be determined by their respective needs or desires. The accounting theorist would probably urge uniformity of treatment and suggest that, if for any particular purpose an exceptional transaction may call for special treatment, the party interested should make his own adjustment if he deems it worthwhile. This, however, seems to me an extremely theoretical solution of what is an intensely practical question.

It is apparent, first, that the interest of some groups is more direct and substantial than that of others, and secondly, that some groups are better able than others to adjust accounts to fit their own requirements. In general, the individual stockholder has the most direct interest and is least qualified to make adjustments. He is entitled to the benefit of the judgment of the executive and the auditor on the question how, in all the circumstances, the special situation should be dealt with. 229

In previous chapters, the writer has examined accounting theory and practice with respect to one of the greatest problems in the preparation of an income statement in discussions of extra-ordinary

or, as in the case of proprietors, consider themselves as identified with the accounting entity.\(^1\)

The concept of a business enterprise as an entity, separate and distinct from its owners has many implications in accounting theory, one of which is the development of consistent and useful viewpoints with respect to the ownership of business income. In the words of Paton and Littleton:

If the corporation were viewed as merely an aggregation of individual investors, it would be consistent to hold that the earnings of the enterprise belonged to the investors from the moment of original realization. Emphasis on the entity point of view, on the other hand, requires the treatment of business earnings as the income of the enterprise itself until such time as transfer to the individual participants has been effected by dividend declaration.\(^2\)

It is not difficult for persons who are acquainted with the corporate method of business activity to conceive of a corporation as a legal entity. That fact has been well established by the courts of law. It might, however, be more difficult for many to visualize this concept as embracing other forms of business organizations. That it is important to realize, for accounting purposes, that the entity concept may be applied to other forms is emphasized by Paton and Littleton as follows:

That the concept of the entity is important for unincorporated as well as incorporated business

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items and corrections of profits of past periods. The two schools of thought in this area are described by Murphy as follows:

Two concepts of the income statement gradually developed, each with its proponents and opponents, the current operating performance concept and the all-inclusive concept. Under the former, accounts excluded from the income statement had to meet certain established standards, they were limited to material amounts, and their omission had to be disclosed. An income statement based on the all-inclusive concept, however, included all items affecting income, irrespective of their nature and regardless of their relation to current operating performance, in the income statement in the year of their recognition. The Committee on Accounting Procedure of the American Institute of Accountants accepted the current operating performance concept because it seemed to meet the needs of readers of financial statements, and urged members to accept the responsibility of distinguishing and treating differently any items which should be considered as affecting current operating performance. In a recent amendment of Regulation S-X, the S.E.C. permits the separate statement of special items after the net income figure, and a final total of "net" income or loss and special items.\footnote{Mary E. Murphy, Selected Readings in Accounting and Auditing, New York: Prentice-Hall, Inc., 1952, p. 140.}

In their list of suggested standards for the preparation of financial statements, the AAA executive committee indicates its approval of the all-inclusive concept. Their propositions follow:

(9) The income of an accounting period should be reported in a statement providing an exhibit of all revenue and expense (including losses) given accounting recognition during that period. This practice assures that the income statements for a period of years will disclose completely the entire income history of that period.

(10) The income statement should be arranged to report consistently and in reasonable detail the
particulars of revenue and the expense pertaining to the operations of the current period, measured as accurately as is possible at the time the statement is prepared and also any items of revenue or expense not associated with the operations of the current period. Such arrangement of data in a single statement discloses both the earning performance and the entire income history of the enterprise during a given period.231

Disagreeing with the all-inclusive concept as the most appropriate standard and supporting the other school of thought is George D. Bailey, who says:

It seems to me that the need for a sharp determination of income of a corporation for a given year is so great as to override any advantage of the all-inclusive income statement in having all items which are "bookkept" during the year shown in one statement—and to override any contention that orderly accounting requires that items get into the surplus account only by means of the income statement. The income statement must be as sharp a presentation of corporate income for one year as it is possible to make it.232

In recent years there is a noticeable tendency among accounting writers and authorities to de-emphasize the significance of the net profit or loss figure for a single year and to recommend that statements of the particular year in question be published together with statements of the past two or three fiscal periods. This will enable the reader to obtain some idea about the trend of a company's activities. It follows, then, that in order for this to be a useful practice,


the statements themselves must be comparable from year to year, in terms of the form, descriptions of items, composition of items, etc. This represents an application of the doctrines of consistency and full disclosure, as any variations should be adequately explained.

In its Bulletin No. 6, the AIA committee on accounting procedure urged the extension of the use of comparative statements. They comment as follows:

The increasing use of comparative statements in the annual reports of companies is a step in the right direction. The practice enhances the significance of the reports, and brings out more clearly the nature and trends of current changes affecting the enterprise. The use of statements in comparative form serves to increase the reader's grasp of the fact that the statements for a series of periods are far more significant than those for a single period—that the statements for one year are but one instalment of what is essentially a continuous history.

It is therefore recommended that the use of comparative statements be extended. In any one year it is ordinarily desirable that the balance sheet, the income statement and the surplus statement (the two latter being separate or combined) be given for the preceding as well as for the current year. Footnotes, explanations and accountants' qualification already made on the statements for the preceding year should be given, or at least referred to, in the comparative statements. If, because of reclassifications or for other reasons, changes have occurred in the basis for presenting corresponding items for the two periods, information should be furnished which will explain the change. This is in conformity with the well recognized rule that any change in practice which would affect comparability should be disclosed.233

With regard to form, income statements may be classified into two groups—multiple-step and single-step. The conventional income statement is of the multiple-step variety, which means that there are several major classifications of items, several totals and sub-totals, as various groups are subtracted and intermediary balances indicated in somewhat a step-by-step sequence from sales to the final figure of net profit. This sort of statement makes use of descriptive titles as "gross profit," "selling profit," "total selling expenses," "total administrative expenses," "other income," "other expenses," "net profit before taxes," and "net profit after taxes."

In contrast to the multiple-step type of statement, the single-step arranges all gross income items at the top and lists all expenses and taxes next to arrive at a total of all deductions from the gross income, which when subtracted gives the net income for the year. Advocates of the single-step type of income statement feel that one of its greatest advantages is simplicity. They hold that all items of income are similar and all expenses have the same final effect and that there is little use in complicating things by a mass of totals and sub-totals. They further state that the arrangement of items in this form leaves it up to a reader to make any types of rearrangements desired while analyzing the statement. The counter-argument is that some of the intermediate balances do have significance, which it is the duty of the accountant to point out by skillful presentation in facilitating the interpretative phase of his function.

The textbook presentation of procedures and rules for the preparation of income statements closely follows that of other current
literature. The opinions of the authors concerning the all-inclusive or current operating performance standards has already been indicated in previous chapters. They emphasize the importance of the earnings statement, recommend the use of comparative statements, and tend to adhere to the traditional form, that of the multiple-step presentation. Most of them, however, mention the single-step form and point out the desirability of seeking continuous improvement in the area of more effective presentation of profit and loss information.

Johnson summarizes the responsibility of the accountant as follows:

With emphasis having shifted from the balance sheet to the profit and loss statement, it is apparent that the responsibility of the accountant has been accentuated sharply. More than ever before it is his obligation to set forth the amount of net income on the profit and loss statement as accurately as expert ability will allow. The profit and loss statement must be adequately informative, it must be inclusive, and it must conform to the consistent usage of sound principles of accounting.\(^234\)

In line with May's comment on the limitations of financial statements, previously quoted, Milroy and Carmichael also point out the necessity of taking into consideration other factors in judging the operations of an enterprise. They say:

The profit and loss statement and balance sheet show only the results of past operations and present financial condition. In themselves they do not exhibit prospects for the future. There are, however, likely to be many available facts relative to the future which must be taken into consideration in any comprehensive analysis of

a particular concern... The point is, that while the past is in many cases reliably indicative of the future, conclusions should not be accepted without supplementary investigation. Any comprehensive analysis of a particular firm will involve several types of approach, of which statement analysis should certainly be one. Other investigations likely to be undertaken should include an appraisal of general business conditions, an examination of conditions affecting the particular industry, and factors of a non-statement character relative to the particular concern such as management personnel, employee-employer relations, and customer attitudes.235

Mauriello discusses both the desirable and undesirable features of what he calls a sectionalized income statement:

The desirable features of this form of income statement follow:

1. Expenses are assembled according to functional subdivisions of the enterprise.

2. Gross profit is segregated as an item of managerial significance. Since cost of sales bears a closer measurable relationship to net sales than do the other component expenses on the income statement, gross profit and the rate of gross profit on cost or on sales price take on a precise meaning to management. Furthermore, cost of sales is variable in relation to net sales, whereas selling and administrative expenses, with a few exceptions, are largely fixed. Management accordingly finds it very useful to relate those fixed selling and administrative expenses to gross profit amounts computed at different sales volume levels.

The objections to the first form of income statement are as follows:

1. The repeated use of the word "profit" is technically incorrect, since the word logically applies solely to the residual amount remaining after the provision for federal income taxes.

2. Certain of the intermediate profit levels lack managerial significance or unrealistically imply sharply defined expense compartments, and as a result merely add to the complexity of the income statement. Thus, the usefulness of "selling profit" as a managerial measure is questionable. Again, the line caption "net operating profit" should give effect to certain financial management expense and income items, such as interest on notes payable and on notes receivable. These financial management elements are a part of everyday operations, and are in no sense nonoperating in character.\footnote{Joseph A. Mauriello, \textit{Intermediate Accounting}, New York: The Ronald Press Company, 1950, pp. 568-569.}

The Balance Sheet

Though it has been frequently stated that the income statement is the most important accounting report, that does not mean that the balance sheet has no significance. Few accountants would take the position that the presentation of published balance sheets should be abandoned. Investors, credit-grantors, and many other interested financial analysts still consider the periodic statement of assets, liabilities, and stockholder's interest a vital source of information concerning the status of an enterprise as of designated dates. As in the case of income statements, the use of comparative balance sheets is widespread.

Most of the concepts and standards concerning the preparation of the balance sheet have already been presented in chapters dealing with the classification, valuation, and description of assets, liabilities, and stockholders' interest. Other than the above areas, the
improvement of balance sheets lies in the further application of the doctrine of full disclosure and the use of terminology which is more meaningful to the average reader of financial statements.

One of the most recent changes which has occurred in regard to form is the so-called simplified balance sheet, which begins with the grouping of current assets, from which the current liabilities are deducted to arrive at working capital. Fixed and other assets are then added, from which fixed liabilities are deducted to leave capital stock, retained income, and other capital items in the last group.

Among the standards advocated by the AAA committee in its 1948 Statement in the preparation of balance sheets are:

(1) Assets should be classified in such a manner as will facilitate the accounting for their utilization and the preparation and interpretation of financial statements...

(3) Assets and liabilities should not be offset unless required by law or contract.

(4) The method of inventory costing should be revealed in the balance sheet.

(5) In exhibiting a long-term liability disclosure should be made of the maturity amount and other significant characteristics of the obligation.

(6) Conditions limiting the disposition of retained income are preferably disclosed by parenthetical comment or footnote...

(13) A change in paid-in capital and retained income such as one resulting from the issuance, acquisition, conversion or exchange of capital stock, and from stock dividends, should be disclosed in the financial statements of the period in which the change occurs...
(14) The balance sheet should contain no special section for reserves. Each reserve should be identified as (a) a subdivision of retained income, (b) an asset or liability valuation account, or, (c) a liability, and the position of the reserve in the balance sheet established accordingly.\textsuperscript{237}

There is considerable agreement among authors of accounting books concerning the preparation of the balance sheet. In most cases, a list of guiding principles is not outlined but the various recommended procedures are presented in connection with the study of specific balance sheet items. Paton writes of the importance of the balance sheet as follows:

The balance sheet is of special value to owners or stockholders, to the creditors, and to officers and general managers. It is the balance sheet which shows the status of each equity in the enterprise, and this statement, accordingly, is of marked significance to those who have committed capital to the undertaking or are contemplating making such commitment. The periodic statement of assets and equities, in particular, throws some light upon the question of solvency, and the relative positions of the various interests as to security. With respect to the single balance sheet this is especially true in the case of short-term creditors. . . For the purposes of owners and other long-term investors, it is of course desirable that a series of balance sheets in chronological order be available, as by such means trends as well as immediate financial relationships may be recognized.\textsuperscript{238}

Mauriello sets forth the following ideas as guiding principles in balance sheet presentation:

\textsuperscript{237}Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948, American Accounting Association, pp. 6-7.

Once the form of balance sheet is selected, the guiding principle to be observed in presenting balance sheet items logically and systematically is to make asset elements comparable to liability and capital elements in the following respects: (1) group classifications and the captioning of groups; (2) sequence of groups; and (3) order of items within each group.\footnote{239}

Mauriello also has quite a bit to say about offsetting assets and liabilities:

Liabilities and capital are not identifiable with specific assets. For this reason liabilities should not be offset against related assets on the balance sheet. This rule applies to assets whose acquisition creates a particular liability and to assets pledged to secure a given liability. An offsetting of the liability against the asset is often attempted in order to show the company's equity in the asset. Such a presentation, however, is incompatible with the fact that the concern intends to retain title to the asset and to pay the liability from general funds. The converse rule also applies, namely, that assets should not be offset against related liabilities.\footnote{240}

As a concluding comment about financial statements, it can be said that most of the current literature on the subject indicates the need for continuous improvement, especially in the matter of form and terminology in order to best serve one of their main functions, which is to provide understandable information concerning the activities and status of a business enterprise to a large number of interested parties. It is probably true that improvements in this area will be an outgrowth of the steady progress which has been made in clarifying other accounting problems and developing a core of useful, acceptable concepts and standards.


\footnote{240}Ibid.
should be emphasized. From the standpoint of administration, it is essential that business affairs be segregated from private or personal affairs. Even if the enterprise is not a corporation, and usually powerless to hold legal title to property, accounting must regard property dedicated to business purposes as being enterprise assets. Considerations of both management and equity call for the reporting of business income, in first instance, as enterprise earnings even if no formal legal action is needed to secure transfer to individual possession. Accounting, in a very significant sense, is institutional, with the 'institution' ranging from the small store to the huge industrial corporation.  

Further evidence of the position of the entity concept as fundamental in accounting theory is its endorsement by the American Accounting Association:

Although seldom given express recognition, accounting concepts are embodied in a framework of underlying conditions and assumptions, such as (a) a business entity with an income objective, (b) a continuity of operations as a going concern, (c) the accrual basis of accounting, (d) the need for periodic reporting, and (e) the preparation, from underlying data, of statements embodying the point of view of stockholders.  

An examination of a selected group of textbooks used in colleges and universities throughout the country reveals that, even though the accounting procedures used imply a recognition of the idea of a business entity, only a few of the authors saw fit to definitely point this concept out as one of the essential assumptions of accounting. The


Chapter XI

SUMMARY AND CONCLUSIONS

The main purpose of accounting is to record, classify, and analyze business transactions in such a way that reasonable accurate presentations can be made with respect to the results of operations and the financial status of business enterprises. Even though business records have been kept since the beginning of trading activities, the profession of accountancy is a rather modern development, as an outgrowth of the needs of present-day business operations.

Several significant changes in our economic, industrial, and governmental life have created new demands for the uses of accounting and have added tremendous responsibilities for those engaged in the various aspects of the profession. Among these factors are the growth of large-scale corporate enterprises, the development of keener competition among businesses, the rise of labor unions, and the increasing amount of governmental regulation and taxation. To a greater extent management, investors, labor leaders, and governmental agencies must place reliance on accounting records and reports for the essential information necessary for efficient business management, fair labor practices, the most effective channeling of capital funds, and equitable tax administration.
With a greater recognition of the role being played by accounting in the business life of the nation came a critical re-examination of the underlying theories, practices, rules, and procedures which have been developed by the profession. This was accentuated by a series of circumstances which led to a serious questioning of how well accounting was measuring up to the task expected of it. Evidences of wide variations in the application of accounting techniques, with different treatment of the same items by various accountants, which resulted in the presentation of financial data for various companies, which was not comparable, which was inconsistent, and generally unreliable, led to much adverse criticism of accounting and accounting methods. The lack of uniformity in accounting practices led to the general criticism that accountants were not guided by any set of principles to which the profession subscribed.

Rising to the support of the profession, the professional accounting organizations and individual leaders in academic and professional circles set forth on a program of research and study to develop such a body of principles and to restore public faith in the profession. This has characterized the history of the profession for the past fifteen years.

As a means of gauging the progress which has been made and to discover areas needing future study and improvement, the writer has attempted in this study to analyze the major concepts and standards which serve as guiding principles for accounting theory and practice as revealed in a selected group of college textbooks and contemporary literature. The writer has also compared the viewpoints expressed in
the textbooks with other current literature. To re-emphasize some of the principal aspects of accounting theory and practice, some of the most significant viewpoints are summarized below.

**Concepts of the General Nature and Scope of Accounting**

The failure of a large number of persons to understand the basic assumptions serving as the framework of accounting methods has undoubtedly been the cause of adverse criticism. The limitations inherent in accounting are not widely appreciated. A review of accounting textbooks and current literature reveals that considerable emphasis is placed on the basic assumptions or conventions of accounting.

The business entity is one of the conventions which serves as a starting point for the development of accounting concepts and standards. This concept considers a business enterprise as a unit separate and distinct from its owners and whose affairs have to be accounted for in a separate manner.241

Another fundamental assumption with regard to business activity and important to the accountant, is that the business enterprise will be in continuous operation for an indefinite period—the "going-concern" theory or "postulate of permanence."242

Closely allied to the going concern theory is the use by businessmen and accountants of an accounting period, in which an attempt is

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made to isolate short segments of the continuous life of an enterprise for the purpose of income reckoning.\textsuperscript{243} Difficulties involved in attempting to determine the net income for one period out of the entire history of a business undertaking constitute one of the important limitations of accounting.

One of the most controversial issues regarding present-day accounting methods grows out of the next two closely related fundamental assumptions— the valuation convention and the assumption of a stable monetary unit. Under the valuation convention various types of assets of a non-homogeneous nature are translated into money values by which they can be accounted for in the business records.\textsuperscript{244} The other assumption holds that for accounting purposes the monetary unit is considered as representing the same value from period to period, thus ignoring fluctuations in price levels. This latter convention is now being subjected to a lot of analysis by those who question its usefulness for accounting purposes.\textsuperscript{245}

The transferred cost convention is of special interest in the field of cost accounting and is basic to an understanding of what an accountant does in tracing costs associated with manufacturing operations. In determining the unit costs of products, processes, etc., the accountant


assumes that costs associated with materials, labor, and overhead items attach themselves to the product as it passes through various stages in the manufacturing process.  

One could hardly analyze the principal conventions and assumptions upon which accounting is based without being aware of the "natural limitations of the accounting mechanism." It should be kept in mind that while accounting is an indispensable tool of management, it cannot substitute for management. With accurate records, a wealth of statistical information, and concise, well-prepared reports at their command, managers must still exercise personal judgment in making the numerous decisions necessary for business progress. Accounting records are not a substitute for a good product, efficient employees, good management, and other favorable factors, which cause one firm to outdistance its competitors.

Accounting is closely related to other fields, such as finance, law, taxation, insurance, and economics. It is in the area of economics, especially, that considerable disputes have arisen between accountants and economists with respect to such matters as the determination of income, valuation of assets, definitions of terms, and many similar issues. Though accounting and economics do deal principally with the

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same types of subject matter, it is important to delimit the field
of each in order to lead to a better understanding of the interrela-
tionships which exist between the two areas.\textsuperscript{249}

**Accounting Doctrines**

Closely related to the basic conventions and assumptions of ac-
counting presented above is another set of ideas which express opinions
with respect to accounting and reporting policies. Gilman considers
them to be most appropriately described as doctrines.\textsuperscript{250}

Perhaps foremost among these four doctrines is that of disclosure,
which advocates that all information pertinent to the correct interpre-
tation of accounting reports should be presented to the readers
thereof.\textsuperscript{251}

Under the doctrine of materiality, the method of accounting for a
particular item may differ on the basis of the amount of the dollar
valuation involved, rather than the nature of the item. Thus, whether
the cost of an asset is capitalized and systematically amortized over
a series of accounting periods or merely charged off as an expense in
one period may depend upon whether the amount of the expenditure is
significant, rather than whether the asset itself will last more than
one period.\textsuperscript{252}

\textsuperscript{249}Perry Mason, George E. Stenberg, and William Niven, *Elementary Ac-


\textsuperscript{251}H. A. Finney and Herbert E. Miller, *Principles of Accounting, Inter-

\textsuperscript{252}Leonard W. Ascher, *Survey of Accounting*, New York: Harper & Brothers,
The doctrine of conservatism carries a central theme of caution, indicating that it is better to understate the financial position of earnings picture of an enterprise rather than to overstate. It is reflected in such a rule as "do not anticipate profits but provide for all losses."

According to the doctrine of consistency, the accounting treatment of items of a similar nature should be the same from period to period. Upon the occasion of a deviation from a previous method of handling a certain item, adequate disclosure should be made.

Revenue and Income

Many of the most important concepts and standards which have been developed in accounting theory and practice are involved in the area of income accounting. Various aspects of income accounting considered in this study included the nature of income, proposals relative to the influence of changing price levels on the determination of income, standards and rules adopted for the determination of periodic income, and special problems of income accounting, such as depreciation and inventory valuation.

One of the most significant aspects of present-day financial reporting and one which has exerted a tremendous influence on accounting


techniques has been the shift of emphasis from the balance sheet to
the income statement. Thus, it is now generally considered by ac­
counting writers that the most important task of the accountant is to
determine, in the most accurate manner, the periodic net income of a
business enterprise.255

changing price levels and the determination of
net income

In recent years, characterized by an era of steadily rising prices,
many economists, business men, and accountants have questioned the use
of several accounting techniques which are based upon the assumption
of a stable monetary unit. One school of thought takes the attitude
that customary methods of income accounting are presenting erroneous
impressions concerning the net profits of business firms. Broad is one
of the writers who advocate the adoption of techniques which will reveal
the effect of inflation on business income.256 Another school of thought
would adhere to the time-honored methods of income determination as the
most objective and useful procedures, being well understood by the gen­
eral public, and deeply embedded in the various laws of the land. They
further state that the effects of changing price levels are exaggerated.257


257Edward B. Wilcox and Howard C. Greer, "The Case Against Price-Level
Adjustments in Income Determination," The Journal of Accountancy,
December, 1950, pp. 492-504.
The outgrowth of the discussion with regard to changing price levels and the determination of income seems to indicate a trend toward an extension of the accountant's responsibility in the area of preparing financial statements or supplementary statements in such a way that readers may be made aware of the effects of price-level changes on the earnings statement and on the financial condition.\footnote{Price Level Changes and Financial Statements, American Accounting Association, The Accounting Review, October, 1951, pp. 468-474.}

One procedure by which this can be accomplished is by the use of index numbers representing general purchasing power.\footnote{John E. Kane, "Changes in the Price Level in Relation to Financial Reporting," The Accounting Review, October, 1951, pp. 496-502.}

**Matching Income and Expenses**

One concept which appears frequently in accounting is the so-called matching of costs and revenues in the determination of periodic income. In its most theoretical and ideal form, each item of realized revenue would have charged against it the costs which were incurred to produce it. Net profit, or net income, would then emerge as the excess of the revenue over the assigned costs.\footnote{W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, American Accounting Association, 1940, p. 7.}

There has been quite a bit of criticism of the matching process, either from the standpoint of its usefulness as a standard for income accounting or from the standpoint that it does not represent what accountants actually do. MacKenzie points out that absolute matching of costs and revenue is not always done because in some cases the expense would be too great, it is often
impossible, and some costs are so immaterial that they might as well be assigned on the basis of time and not their association with revenue. 261

Unusual Gains and Losses

One of the most complex problems in the measurement of periodic net income has to do with the disposition of expenses, losses, and gains of an unusual nature, and corrections of profits of past periods. Three schools of thought have developed in this area. One group supports the all-inclusive concept which would include all items of expense, losses, gains, and corrections in the period in which they are recognized. Among those who advocate the all-inclusive standard are the American Accounting Association, 262 Paton and Littleton, 263 and Bolon, Fleig, and McCoy. 264 Another group believes that extraordinary items should be eliminated from the current determination of net income, which measures earning ability. 265 Still another group would handle the items different ways depending upon such factors as the nature of the items and their sizes. 266


264 Dallas S. Bolon, Wilfred Fleig, and James R. McCoy, Introduction to Accounting, Columbus, Ohio: 1950, p. 126.


quotations below are examples of the type of presentation made on this point when specific mention was made:

...Thus accounting is particularistic, being concerned solely with the financial experience and problems of the enterprise for which the accounting is being made. Data of other concerns do not affect the accounting for the enterprise. This individualistic view stems from the affairs of the particular concern.5

The concept of an enterprise as a unit or undertaking for which financial records should be classified and kept, summarized, and interpreted is absolutely essential in accounting. It is common, therefore, for each business establishment to have its own accounting system and to be treated as an entirely separate unit, something apart from its owner or owners.6

For accounting purposes, every business organization is considered as a unit, separate and distinct from its one or several owners. Accountants look upon each business unit as the owner of all the properties of the business and as being responsible for its debts.7

Statements similar to those above relative to one of the basic concepts of accounting are useful in helping the student understand the nature of accounting, its aims, and limitations. Such concise statements of the entity theory do not leave it up to the students by chance to glean it from a mass of procedures and problems presented.

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Depreciation

Perhaps in no other area of accounting has there been so much controversy as in the case of depreciation accounting. One factor leading to considerable misunderstanding with regard to depreciation is a failure to understand the accountant's concept of the nature of a depreciation allowance. As reflected in present-day theory and practice, accountants conceive of depreciation accounting as a systematic process of allocating the cost of fixed assets over the period of their useful life, and not as a process of valuation.267

Conclusions

A few of the most important concepts and standards of accounting have been outlined above. A more detailed treatment of these and other standards appears in the complete report of the investigation. Upon the basis of his findings, the writer concludes that there is general uniformity and agreement among leading accounting writers with regard to the most important, basic concepts and standards of accounting. During the past ten or fifteen years a number of highly controversial issues in accounting have been settled, resulting in the establishment of certain underlying standards which have found widespread favor among the members of the profession.

Indeed, it can now be said that there are few areas where significant differences of opinion exist. This does not mean that the search

for accounting principles has ended. Rather, it signifies only that much progress has been made and that it can be said with a reasonable degree of assurance that the members of the profession will continue to apply themselves toward the improvement of existing techniques and standards and toward seeking out better and more useful ways to make financial reporting more useful, accurate, and understandable.
APPENDIX
ACCOUNTING TERMINOLOGY

It can hardly be denied that much misunderstanding of the nature of accounting and accounting techniques is due to misconceptions with regard to accounting terminology. In an attempt to eliminate this problem the American Institute of Accountants set up a committee on terminology in 1920 to assume the task of compiling a vocabulary of words and expressions used in accounting and gradually preparing definitions thereof. The committee published a volume of definitions in 1931 under the title "Accounting Terminology," which was tentative in character. Since 1940, the committee on accounting terminology has been a sub-committee of the committee on accounting procedure. Its work has involved the issuance of special Accounting Research Bulletins on various terms used in accounting. These bulletins have dealt with such items as definitions of accounting, depreciation, balance sheet, value, audit, surplus, and reserves.

In commenting on the problems existing in accounting terminology, the committee divides the words and phrases into four classes as follows:

First, there are words or phrases that are fundamental and are used in accounting in senses more or less at variance with the senses which attach to them in the public mind. (Value, assets, liabilities, surplus, etc.) Second, there are a small number of purely technical terms developed by accountants and unfamiliar to the public, such as balance sheet, double entry. Third, there are
words originating in other fields, particularly law and business, with which the accountant is frequently concerned. Fourth, there are terms used in auditing as distinct from accounting.

In another statement pointing out the importance of clarifying the use of certain terms in accounting, the committee states:

The failure of accountants to emphasize the conventional uses of such terms has given rise to much unwarranted criticism of accounts and of the profession. Students from other fields discovering these uses, and finding no extensive recognition of them in the literature of the profession, are apt to regard as revelations and as grounds for severe criticisms what are really truisms accepted by regulatory bodies, accountants and business men generally.

A question may no doubt be raised whether all such uses are necessary or expedient or whether some should be abolished.

Over a period of approximately a decade, the committee on terminology has issued several bulletins. In this study, the writer will call special attention to two, in which definite statements were made urging the discontinuance of certain usages of two well-known words in accounting—"surplus" and "reserve."

In Bulletin No. 34, issued in October, 1948, the committee presented a statement on the use of the term "reserve," from which the following is quoted:

In current accounting practice the term reserve is used in four senses, as follows:

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1. The term is used to describe (a) a deduction which is made from the face amount of an asset in order to arrive at the amount which it is expected will be realized, as in the case of a reserve for uncollectible accounts, or (b) a deduction which is made from the cost or carrying value of an asset, representing the portion of the cost which has been amortized or allocated to income, in order to arrive at the amount properly chargeable to future operations, as in the case of a reserve for depreciation. In this sense reserves are customarily referred to as valuation reserves, and are usually deducted in the asset section of the balance-sheet.

2. The term is used to indicate (a) an estimate of an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) an approximation of the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) an estimate of a liability or loss which is sufficiently likely to occur to require recognition, as in the case of a reserve for self-insurance. These reserves are included in the liability section of the balance-sheet, in a section immediately below the ordinary liabilities, or in the proprietary section. In the insurance field the term is used in this sense as referring to the portion of the total assets derived from premiums which is required to meet future payments under policies.

3. The term is sometimes used, although not in accordance with the best practice as generally recognized, to indicate a variety of charges set forth in the income statement, including estimated losses as a result of uncollectible accounts and other causes, depreciation, depletion, amortization, probable losses, specific contingencies, and similar items. It is to be noted here that the term refers to the charge by means of which a reserve (in the credit sense) is created.

4. The term is used to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose as in the case of a reserve (a) for betterments or plant extensions, or (b) for excess cost of replacement of property, or
(c) for possible future inventory losses, or
(d) for general contingencies. In this sense
a reserve is frequently referred to as an ap­
propriation of retained earnings.270

The committee makes the following comments with respect to the
four usages discussed above:

The first accounting usage of the term set
forth above seems clearly contrary to the com­
monly accepted meaning of the term. A so-called
reserve for bad debts or for depreciation does
not in itself involve a retention or holding of
assets, identified or otherwise, for any pur­
pose. . . While it seems clearly advisable to
drop the term reserve in this area, it should be
replaced by terms which indicate the measurement
process, i.e., such terms as "less estimated
uncollectibles," "less estimated losses in col­
lection," "less amortization to date," etc.271

The second of the four accounting usages set
forth above is also contrary to the generally
accepted meaning of the term. It may be argued,
of course, that the statement of any liability
in the balance-sheet is an indication that a
portion of the assets will be required for its
discharge. In this sense the statement may be
regarded as a provision or reserve. It is
clearly preferable, however, to regard the
statement as indicating the obligation itself
which is a deduction necessary to arrive at
proprietary investment or net assets. The items
in this area described as reserved might better
be designated in some such way as "estimated
liabilities," or "liabilities of estimated
amount.272

The third of the four usages set forth above
involves different considerations since it is
a matter of the income statement rather than
the balance-sheet. In a sense a charge of this
nature in the income statement, e.g., a charge

270 Accounting Research Bulletin No. 34, "Use of Term 'Reserve,'
October, 1948, p. 272.
271 Ibid., p. 273.
272 Ibid.
for depreciation, is a "reserve" in so far as it indicates that cash or other assets received by way of revenues is, to the extent indicated, to be used or devoted to a special purpose. It seems clear, however, that the basic purpose in the making of these charges is one of income measurement and that the designation of such charges as costs, expenses or losses, i.e., elements in the measurement of income, is clearly more understandable than the designation of reserve. 273

The generally accepted meaning of the term reserve corresponds fairly closely to the last of the four usages set forth above, i.e., the indication of an amount of unidentified or unsegregated assets held or retained for a specific purpose. While retention of assets for a variety of purposes is an important phase of corporate management and finance, the retention does not ordinarily involve a segregation. 274

The committee finally concludes that accountants should restrict the use of the term reserve to one meaning. The statement follows:

To summarize, it is recommended that the use of the term reserve in accounting be limited to the last of the four senses set forth above, i.e., to indicate that an undivided portion of the assets is being held or retained for general or specific purposes and that the use of the term in the balance-sheet, in describing deductions from assets or provisions for particular liabilities and in the income statement be discontinued. 275

That Bulletin No. 34 has had a great influence upon textbooks is observable from the large number of authors who have adopted the suggestions of the committee and have limited their use of the term

273*Accounting Research Bulletin* No. 34, "Use of Term 'Reserve'," October, 1948, pp. 273-274.


"reserve." There is evident a tendency to adopt the titles "Allowance for Depreciation," "Allowance for Bad Debts," or "Allowance for Uncollectible Accounts." Among the authors adopting the above titles are: Tunick and Saxe,276 Ascher,277 and Mason, Stenberg, and Niven.278 Bolon, Fleig, and McCoy279 make use of "accumulated depreciation," with Mauriello280 doing likewise.

In his discussion of the use of the term "reserve" for various types of accounts, Ascher calls them "spurious reserves." He writes:

While true reserves are part of the proprietorship and are derived from surplus by making a transfer from surplus to the reserve account in question, there are other accounts which are in practice called reserves but which are in truth no reserves at all. They are spurious reserves. They are not proprietorship, and they do not arise from surplus or undistributed profits. . .

One of the most common uses of the term "reserve" is in the "reserve" for depreciation. This is not a reserve at all and should be described as an allowance for, not a reserve for, depreciation.281

In Bulletin No. 39, the subcommittee on terminology suggests another drastic modification of accounting terminology, the discontinuance of the use of the term surplus. In its discussion of the term, the committee states:

While the terms capital surplus and earned surplus have been widely used, they are open to serious objection.

1. The term surplus has a connotation of excess, overplus, residue or "that which remains when use or need is satisfied." (Webster), whereas no such meaning is intended where the term is used in accounting.

2. The terms capital and surplus have established meanings in other fields, such as economics and law, which are not in accordance with the concepts which the accountant seeks to express in using those terms.

3. The use of the term capital surplus (or as it is sometimes called, paid-in surplus) gives rise to confusion. If the term surplus is intended to indicate capital accumulated by the retention of earnings, i.e., retained income, it is not properly used in the term capital surplus. Further, if the term surplus is intended to indicate a portion of the capital, there is an element of redundancy in the term capital surplus.

4. If the term capital stock (and in some states the term capital surplus) be used to indicate capital which, in the legal sense, is restricted as to withdrawal, there is an implication in the terms surplus or earned surplus of availability for dividends. This is unfortunate because the status of corporate assets may well be such that they are not, as a practical matter, or as a matter of prudent management, "available for dividends."282

A second fundamental assumption with regard to business activity, and, likewise, important to the accountant is that the business enterprise will be in continuous operation for an indefinite period. This is frequently called the "Going Concern Theory," or "postulate of permanence." As it affects the accountant, this concept means that the accounting treatments with regard to valuations of assets are made in that light and not in terms of an enterprise which is facing liquidation. No doubt, many of the problems which have to do with the valuation, definition, and classification of assets in periodic balance sheets grow out of a failure to appreciate the importance of the going concern theory. Like the entity concept, this assumption too has received wide recognition in contemporary accounting literature.

The Study Group on Business Income termed it the "postulate of permanence," stating:

In the absence of actual evidence to the contrary, the prospective life of the enterprise may be deemed to be indefinitely long.®

In considering the validity of this assumption, the members of the group commented:

The postulate of permanence seems to be almost completely valid over a wide and increasing area. It is in harmony with the assumption applied in measuring income of individuals; the life expectancy both of human beings and of enterprises that survive infancy is lengthening. Many of our enterprises have reached their fiftieth year of existence or have even longer records... Large enterprises may have to be reorganized, but they are seldom liquidated.®


®Ibid., p. 46.
The committee concludes:

In view of the foregoing the subcommittee recommends that, in the balance-sheet presentation of the stockholders' equity:

1. The use of the term surplus (whether standing alone or in such combination as capital surplus, paid-in surplus, earned surplus, appraisal surplus, etc.) be discontinued. .

2. The term earned surplus be replaced by terms which will indicate source, such as retained income, retained earnings, accumulated earnings, or earnings retained for use in the business. In the case of a deficit, the amount will be shown as a deduction from contributed capital with appropriate description.

It should be noted that Bulletin No. 39 was issued in 1949 and, because of that, enough time has not passed to obtain a reliable picture of the extent to which the textbook writers have adopted the recommendations made. As has previously been stated, the textbooks used in this study were published during the period 1946-1952; therefore, some of them were printed before Bulletin 39. However, the fact that some authors have recognized the problem is illustrated by the following comment by White:

The term "surplus" is an unfortunate selection of a designation for this important part of corporate proprietorship because of the inaccurate and misleading meanings which the term seems to imply. It has been said that to some "surplus" means "an excess" or "too much," or that it is the amount of "cash available for dividends." To avoid some of this misunderstanding, some corporations have discontinued using the term "surplus" altogether and are

using more meaningful terms such as "profits retained in the business," "income reinvested in the business," and other descriptive labels.284

Among those who have adopted the term "retained income" are Bolon, Fleig, and McCoy;285 and "retained earnings" is used by Mason, Stenberg, and Niven.286 Finney and Miller take the following attitude toward the proposals of Bulletin No. 39:

It is also observed that, while the bulletin mentions terms which may be substituted for earned surplus, it suggests no substitutes for such terms as capital surplus, paid-in surplus, and deficit—an omission which somewhat impairs the usefulness of the bulletin and which may act as a deterrent to the general adoption of the committee's recommendations.

At the date of writing this chapter, insufficient time has elapsed since the issuance of the bulletin to determine the extent to which the recommendations of the committee may modify traditional terminology. It is not easy to uproot words which, because of long-established usage, have become embedded in the vocabulary—even when the reasons for attempting to do so are as good as those mentioned in the bulletin. Therefore, it does not seem expedient to eliminate wholly from a textbook the terminology which has long been in use and substitute terminology which may or may not be ultimately accepted.287


Ascher uses rather colorful language in writing about the controversial "surplus." He writes:

Surplus is one of those vestigial remnants that appear in accounting because they were used in the past. That it has outlived its usefulness is attested by the suggestion that the term be abandoned altogether in favor of more descriptive title "undivided profits." Even more misleading than the term "surplus" is the use of such account titles as Capital Surplus, Paid-in Surplus, Donated Surplus, and Appraisal Surplus. No tears should be shed, therefore, when use of the word "surplus" is dropped completely. However, the term is at present in wide use and may be encountered in a variety of accounts, so that anyone studying accounting must be aware of its use. A clear understanding of the various surplus accounts is, therefore, very much in order for those who wish to see the contemporary accounting picture in its proper perspective.288

A new book by Kohler was released too late to be given due consideration in this study.289 However, a rapid perusal of its contents indicates that it will do much to standardize accounting terminology, if the definitions and interpretations appearing therein are widely adopted.


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In referring to the going-concern concept, George O. May writes:

It is almost an essential postulate of accounting that it shall be regarded as a continuous process. The emphasis on profits has sometimes led to attempts to isolate an accounting period from its past and future in some important respect. . . . The life of an enterprise, like that of a man, is continuous, and the gains and losses, the successes and failures, of one period are in a large measure the result of acts, omissions, and events of the past, and the results achieved cannot be appraised as successes or failures without regard to the future.10

Paton and Littleton make the following observations:

Business in general does not consist of an array of sporadic, short-term ventures and its accomplishments are not normally subject to the test of complete liquidation. Liquidation is not the normal expectations; continuity is.11

The possibility of abrupt cessation of activity cannot afford a foundation for accounting, although the accountant may on occasion be called on to report situations in which such a condition is imminent. Accounting standards must rest primarily on normal or typical conditions.12

The 'going concern' or continuity concept had an important bearing on periodic reports. . . . It should be recognized that financial statements, even under the most favorable circumstances, are provisional in character; the impressions gained from them and the decisions resting upon them may have to be changed in the light of future events and should be tempered with a knowledge of this contingency. . . . The complete picture of an enterprise is never entirely discernible prior to final liquidation.13

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12 Ibid.

13 Ibid., pp. 9-10.


I, Lincoln Jay Harrison, was born in Tylertown, Mississippi, July 7, 1919. I received my elementary education at Covington-Rosenwald School, Covington, Louisiana, and secondary school education at the Southern University High School, Baton Rouge, Louisiana. My undergraduate training was obtained at Southern University, from which I received the degree Bachelor of Science in 1938. From Atlanta University I received the degree Master of Arts in 1944. I also received the degree Master of Science from the University of Illinois in 1946, which I attended through the aid of a fellowship from the General Education Board. In 1946 I passed the examination for Certified Public Accountant in the State of Louisiana. My study at The Ohio State University began in 1949, where I specialized in the Department of Accounting. In 1952, I received an appointment as a University Scholar while completing requirements for the degree Doctor of Philosophy.
ACKNOWLEDGEMENTS

The writer wishes to express appreciation to his wife, Joyce, whose unceasing cooperation and encouragement made the completion of this work possible.

He also desires to give recognition to his parents, Mr. and Mrs. J. A. Harrison, his first teachers, whose constant sacrifices have enabled him to reach this stage of educational development.

Lincoln J. Harrison

March 6, 1953
It can hardly be doubted that authors of college textbooks in accounting are aware of the implication of the "going concern" concept, but few of them give express recognition to that assumption in various discussions of accounting methods. Finney and Miller make the following comment:

In the computation of periodic income, the accountant assumes that the business involved is going to continue operations. This assumption makes it unnecessary for him to estimate forced-sale or liquidation values. In fact, the net income determination process cannot be characterized as being predominantly a 'valuation' process. It is a process of determining what income has been earned during a period, what costs have expired during the period, what costs may properly be regarded as residues which will be of benefit to a going concern in the future.14

Closely allied to the going concern theory and probably too inter-related to be considered a separate convention is the use by businessmen and accountants of an accounting period, in which an attempt is made to isolate short segments of the continuous life of an enterprise for the purpose of income reckoning. The importance of the accounting period is mentioned by Paton and Littleton in the following manner:

The flow of business activity has a long continuity; the outcome of the activities lies in the future. But decisions cannot await the ultimate outcome; management, investors, government, all of the interested parties, need 'test readings' from time to time in order to gauge the progress made. By means of accounting we seek to provide these test readings by a periodic matching of the costs and revenues that have flowed past 'the meter' in an interval of time.15


The 'period' is one of the important conventions of accounting.16

Stephen Gilman sees the convention of accounting period as a factor in creating many of the problems facing the accountant. He comments:

One may fairly conclude that the convention of financial periods is responsible for the numerous problems of capital and revenue and is also responsible for that most important accounting report, the periodic profit and loss statement.17

Certainly, there is general recognition of the fiscal period in accounting texts and a discussion of its meaning, but little effort has been made to signify its importance as the basic factor with regard to many of the limitations of accounting.

One of the most controversial issues regarding present-day accounting methods grows out of the next two closely related fundamental assumptions—the valuation convention and a stable monetary unit. In a later chapter current proposals which are being made with respect to the latter assumption will be reviewed in a more detailed manner. In this chapter, mention is only being made of the extent to which these concepts are recognized as basic assumptions of accounting. Concerning the valuation convention, Gilman says:

By this convention non-homogeneous assets and claims to assets are translated into financial equivalents or money values. Thus the man who owns a sheep, a cow, and a horse may translate these possessions into $5, $50, and $100, and will say that he has assets of $155.18

16 W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 1940, American Accounting Association, 1940, p. 22.


There is one textbook in which the valuation convention is pointed out as being significant. The statement appearing therein is being presented later in the summary for this section of the chapter.

According to the Study Group on Business Income the "monetary postulate" indicates that:

Fluctuations in value of the monetary unit, which is the accounting symbol, may properly be ignored. 19

The Study Group makes the following appraisal of the "monetary postulate":

Stated in the form in which it is often presented—that accounting assumes the stability of the monetary unit—the monetary postulate is an obvious fiction. Some have sought to strengthen its position by making it a part of the definition of income. Apart from definition it may be justified as one of those fictions that are acceptable because they produce more useful results than can be secured by adoption of a different assumption. 20

Paton and Littleton state:

The assumption that recorded dollar cost continues to represent actual cost permeates accounting thought and practice, as it does the law. Accounting, in other words, assumes a stable measuring unit. In periods of major price movements this assumption is clearly invalid for certain purposes, as has been pointed out by various writers in recent years. Undoubtedly, interpretative accounting faces a challenge at this point. 21


20 Ibid., p. 46.

George O. May casts a little doubt on the validity of the assumption in the following observation:

In formulating a statement of principles of accounting, as in a general discussion of principles of economics, it is customary to assume that the monetary unit is substantially stable in value; but . . . it is not universally true, and in dealing with any case it is always necessary to consider to what extent the postulate is valid in the particular set of circumstances, or how its invalidity affects the conclusions to be reached.22

In only three of the textbooks studied did the authors place emphasis on either the valuation convention or the assumption of a stable monetary unit. Mackenzie makes the following presentation:

The accountant presents information in terms of the monetary unit, which in the United States is the dollar. This is done not only because business transactions are made on this basis but because no better method is available. Other methods have been suggested. Some people believe that accounting data should be presented in terms of the purchasing power of dollars rather than in legal dollars. Accountants do not favor a change from the legal dollar to any other method of measurement because these other methods are not free from deficiencies.23

In a textbook for beginning accounting students Paton points out weaknesses of the assumption of a stable monetary unit:

The yardstick employed by the accountant in his efforts to record and interpret the financial affairs of the business enterprise is the dollar, and unfortunately this yardstick is not a stable, unchanging quantum as are the standard units used in physical measurement. The value of the dollar,


its purchasing power in terms of the general price level, is a continuously fluctuating amount and in times of major price movements such value may be doubled, or cut in half, in that the data resulting from the use of conventional accounting procedures and rules of valuation may be subject to serious limitations as expressions of true costs and may furnish no evidence whatever of certain important types of gain and loss.\(^{24}\)

The transferred cost convention is of especial interest in the field of cost accounting and is basic to an understanding of what the accountant does in tracing costs associated with manufacturing operations. In determining the unit costs of products, processes, etc., the accountant assumes that costs associated with materials, labor and overhead items attach themselves to the product as it passes through various stages in the manufacturing process. This serves as the basis for the valuation of goods in process and finished goods.

In the preceding paragraphs the writer has analyzed statements setting forth the fundamental assumptions and conventions of accounting as expressed in contemporary literature. Frequently, other procedures or concepts of accounting are listed as basic, but it is believed that the above constitute the most frequently mentioned and most emphasized ones. A review of a selected group of textbooks used in college classes indicates a failure to emphasize these assumptions in a manner which seems warranted in order to convey understanding of what the accountant is trying to do and why. As a means of summarizing the foregoing and also to present what the writer considers as a model

type of presentation which could be made, the following statements
which appear in Ascher's textbook as a means of summarizing this
information are presented herewith:

Entity convention—The first convention is that
of the separate entity. Accounts are kept for
each enterprise or venture as though it had no
managerial or ownership connection with any
other venture. . .

Valuation, or financial, convention. The second
of the major assumptions upon which accounting
theory rests is the valuation, or financial, con­
vention. This convention holds that all business
transactions can be expressed in dollar units.
This results in many entirely different things
being paraded in the uniform of dollars. . .

Going Concern Convention. The third major assump­
tion is the going concern convention. This holds
that the enterprise will continue in operation for
an indefinite time; that there is no specific or
foreseeable date of termination in sight. Under
this supposition, accounts are kept as though the
activities of the company would never be brought
to a conclusion.

The Fiscal Period Convention. The fiscal period
convention is the fourth of the basic assumptions
or propositions in accounting. It is the common
practice, to which accounting must accede, that
there should be a casting up of results at regular
intervals, usually yearly. . . Yet it is not easy
to take a going concern in full career and arbi­
trarily set aside a part of the continuing opera­
tions for summarization as profit or loss for a
limited period. . .

The Transferred Cost Convention. . . The transferred
cost assumption holds that certain expenses of pro­
duction are transferred to the value of the product.
. . The value of the finished goods on hand is the
sum of expenses required to produce them. Partly
finished goods are also valued by ascertaining the
cost incurred in their production up to the stage
they are in.25

25Leonard W. Ascher, Survey of Accounting, New York: Harper & Brothers,
1952, pp. 343-346.
Another important consideration with regard to the textbook treatment of the fundamental assumptions is: "Where are they discussed in the textbook"? One should observe that the last quoted author summarizes the entire matter in one section of his book. Perhaps, the criticism that can be made against his method of a treatment is the matter of placement. Instead of discussing such matters early in the course, he waits until Chapter 22, entitled "Accounting Theory and Principles." The writer believes that the most effective location for such a presentation is early in the first part of the textbook, preferably the first chapter. Some authors make mention of the conventions in a scattered way in various sections of their textbooks. However, it does seem more appropriate to group them as Ascher has done.

Limitations of Accounting Techniques

One could hardly analyze the principal conventions and assumptions upon which the body of accounting rules, procedures, and standards is based, without being aware of "natural limitations of the accounting mechanism." If not specifically pointed out, certain aspects of what accounting cannot do or should not be expected to do are surely implied. Though recognizing the tremendous importance of accounting as summarized in Chapter 1 of this study, one should keep in mind that while accounting is an indispensable tool of management, it cannot substitute for management. With accurate records, a wealth of statistical

information, and concise, well-prepared reports at their command, those responsible for the direction of the enterprise must still exercise personal judgment in making the numerous day-to-day decisions which are necessary for business progress. Accounting records are not a substitute for a business "personality," created by a good product, efficient employees, good management, etc., which causes one firm to outdistance its competitors. Accounting records of past activities can chart the course of future business progress but other forces must bring it to being, or other forces may interfere with hoped-for accomplishments.

A perusal of accounting literature reveals that several writers do seek to emphasize the limitations of accounting. Typical of these is the following:

Many leading bankers, lawyers, and business men feel that a too great devotion to mathematical accuracy in accounting statements may tend to mislead, or to result in overlooking the broader aspects of the matter. Men of experience know that political, social, and economic forces may cause losses which cannot be specifically foreseen, and they look to accountants of larger mold to indicate the unfavorable possibilities. 27

In the following comment, the Committee on Accounting Concepts and Standards of the American Accounting Association briefly indicates that accounting has limitations:

Although a comprehensive understanding of the financial position and operating activities of a corporation is derived only in part from financial statements, it should nevertheless be possible for a person moderately experienced in

business and finance to obtain from such statements basic information on which he may rely with confidence.28

In a discussion of the cost and value approaches to accounting, George May writes:

It is undeniable, though not fully recognized outside of the profession, that books of large enterprises are kept predominantly on a cost basis and do not, therefore, constitute evidence of the value of either the enterprise as a whole or the separate assets thereof, particularly the capital assets. This might be deemed to be a serious defect of accounting procedures but for two considerations: first, that the value of the enterprise is seldom a material fact; and, secondly, that when it is, it can only be measured by looking ahead. The sole relevance of accounts of the past is as throwing light on the prospects for the future.29

According to Paton and Littleton:

Accounting might seem to be scientific in point of view since it deals in some measure with objectively determined facts. Accounting, however, can never become completely scientific, because its factual materials can never be determined with complete and conclusive objectivity. Business does not lend itself to laboratory analysis and its activities do not follow mathematical formulae. The business future is not even predictable in mass, to say nothing of being predictable for individual enterprises. Hence accounting facts are not always conclusively objective or completely verifiable.30

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Concerning the limitations of the balance sheet, Mauriello states:

The balance sheet includes many items of opinion and judgment, and hence cannot reflect the factual status implied in the word "condition." Exactness in result is present only at the time of dissolution of the enterprise, and also at the time of inception where the investment is limited to cash or other assets whose values are objectively determinable.

Many contingent assets and liabilities are omitted from the balance sheet because it is impossible to measure them with financial exactitude. Yet these items may considerably modify current financial status.

Events may be of a character which cannot be measured in money, and therefore are not reflected in the accounting records. These events may profoundly affect financial condition, as may be seen in such factors of general impact as taxation, regulatory laws, labor relations, and demand for the company's products.31

**Accounting and Economics**

Accounting, being a mechanism designed to record, analyze, and report on financial transactions, is naturally closely related to many other fields, which are concerned with property, property rights, income, value, capital, etc. Among these may be mentioned finance, law, taxation, insurance, and economics. It is in the area of economics, especially, that considerable disputes have arisen between accountants and economists with respect to such matters as the determination of income, valuation of assets, definitions of terms, and many similar

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issues. Though accounting and economics do deal principally with the same types of subject matter, it is important to delimit the field of each in order to lead to a better understanding of the interrelationships which do exist between the two areas.

That it is important for economists and accountants to be in harmony with respect to certain fundamental concepts and procedures is attested to by the fact that the Study Group on Business Income, previously referred to, consisted of accountants, economists, and lawyers.

Of the textbooks examined in this study, several made special references concerning accounting and economics, many of them emphasizing particularly the value of courses in economics for students of accountancy. According to Paton:

The economist as a rule adopts the general or social point of view; he looks at the economic fabric in terms of communities, states, markets, basic functions and factors. The accountant, as has been emphasized, is concerned primarily with the activities of the particular enterprise and the interests and needs of its managers and owners. Failure to recognize this contrast has undoubtedly been largely responsible for the persistence of the doctrine that in the operating accounts of the business concern explicit allowance must be made for all factors which are viewed by the economist as price-influencing costs of production, whether or not they are actually incurred by the particular enterprise. Such doctrine represents an unreasonable application of economic concepts and principles to accounting.  

Concerning the different points of view inherent in the two fields, White writes:

There is, however, a difference in the point of view of the economist and the accountant. The

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economist studies and interprets the effects of certain business methods and their results with reference to society as a whole. He thinks in terms of markets, communities, states, and the like. The accountant, on the other hand, looks at these same questions from the point of view of the owner or manager of a single business enterprise. The accountant, however, must understand the general principles of economics in order correctly to interpret the effect of general business conditions upon his business and the part his business will play in the entire economic life of which he is a part. 33

The writer believes that a very good brief explanation of the two fields, their differences, and interrelationship is given by Mason, Stenberg, and Niven as follows:

Economics, as a social science, concerns itself with the struggles of man to make a living. In order to make possible the exchange of goods and services on a large scale and in a complex society, systems of money have been devised. Accounting uses the money system to record the exchanges, the granting of credit, the collection of taxes, and the many other activities of economic life. Accounting provides much of the information which determines the economic action of individual buyers and sellers of goods and services—what to produce, the cost of production, the gain or loss from selling the produced goods, etc. It would seem, therefore, that accounting should be an indispensable and important part of economics; it should provide the information on which economic actions are based and from which economic conclusions are drawn.

In spite of this apparently intimate relationship between economics and accounting, the two fields have developed to a considerable extent as though the connection were incidental. Students of both subjects soon discover that such terms as cost of production, rent, capital and distribution are used quite differently in the two fields. Seldom is any attempt made to reconcile the discrepancies and to present both subjects as related parts of the whole economic pattern.

There are a number of differences between accounting and economics which help to account for the independent development of each field. The accountant is almost always concerned with the problems of a particular business enterprise while the economist is more apt to be interested in the problems of an entire industry or of the 'economy as a whole'. Accounting deals almost continuously with the day-to-day events of business operations, while much of economic reasoning can properly be applied only to long-run problems. As will be seen when we get further into the subject, accounting employs many arbitrary procedures and does not pretend to be able to compute an absolutely correct cost of producing anything; economic theory necessarily assumes a degree of accuracy which cannot be reached in practice. . .

In spite of the confusion and difficulties which are found in the relationship between accounting and economics, it is still true that many of the statistics used by economists are produced by the accountants. It is important that each should have a good comprehension of the needs of and methods employed by the other.34

Chapter III
ACCOUNTING DOCTRINES

In the previous chapter, there was presented a group of propositions which have attained status as basic assumptions and conventions of accounting, being recognized as such to a considerable and harmonious extent in college textbooks and current literature. Closely related to those conventions and very difficult to distinguish in terms of precise shades of meaning is another set of ideas which express opinions with respect to statements of accounting and reporting policy. Gilman considers them to be most appropriately described as doctrines.35

Accounting literature places emphasis on four such doctrines—disclosure, materiality, conservatism, and consistency.

Perhaps foremost among these four doctrines is that of disclosure, which indicates that all information pertinent to the correct interpretation of accounting reports should be presented to readers thereof. In recent years considerable emphasis has been placed on various means of implementing this concept. Among examples are the encouragement of the use of generous descriptions or footnotes to designate such things as: basis of asset valuations, the existence of material contingent liabilities, arrearages of preferred stock dividends, and probable price losses

on future commitments, special information about particular balance sheet items, the placement of operating and nonoperating profit and loss items on income statements, and many more methods of presentation. Several proposals to show the effect of changing price levels by the use of supplementary statements represent an extension of the doctrine of full disclosure. A more detailed discussion of the last problem will appear in a later chapter.

Concerning disclosure, Sanders, Hatfield, and Moore write:

No information should be omitted which, if disclosed, would materially alter the impressions given by the statements.36

In support of the above, the Committee on Accounting Procedure of the American Institute of Accountants makes the following comment:

With full disclosure of the nature of any special or extraordinary items, this group believes the user of the financial statements can make his own additions or deductions more effectively than can the management or the independent accountant.37

It cannot be denied that authors of accounting textbooks exhibit an awareness of the adoption of the doctrines or rules mentioned above because of many of the techniques emphasized in such things as the presentation of balance sheet information, and the use of the cost-or-market inventory rule. Several authors thought it worthwhile to include in their textbooks specific mention of the effects of these doctrines on


accounting policies. The following illustrate the types of statements made about disclosure:

This principle requires the accountant to disclose all financial information compatible with business ethics and recognized standards of business conduct. Modern financial statements are made complete through parenthetical references in the body of the statement and by supplemental footnotes as to bases of valuation employed, accounting policies followed, changes in accounting policies and methods, and contingent and indeterminate items. The resulting clarification of financial data has done much to increase the confidence of outsiders in the integrity and utility of financial statements. 38

All of accounting theory and practice is directed toward the determination of the truth and the facts of a given economic situation. The results cannot be obtained with an absolute degree of accuracy, since too many estimates are normally required, but deliberate distortion, concealment or 'slanting' of the figures is a rare occurrence as far as accountants are concerned.

Related to this quality of truthfulness is the doctrine of full disclosure, that is, the accounting statements should disclose completely and clearly all information which is necessary to enable everyone concerned to make intelligent decisions. 39

The accountant is not a prophet, and he should never assume the position of forecasting the future. But, at the same time, he must recognize that his reports are likely to be used as indications of probable future earnings and probable future financial position. He is under certain obligation, therefore, to disclose matters occurring after the balance sheet date but before the year-end statements are completed and released which materially affect the operating results or financial position portrayed by the financial statements. 40


Thoughtful critics of accounting are usually willing to concede that many weaknesses due to the form and method of preparing accounting reports can be largely offset if the accountant follows faithfully the rule of full disclosure. 41

The doctrine of materiality has to do with the relative importance of items in the determination of income or the presentation of financial information. Thus, in the application of the doctrine, the accountant asks himself, what is the effect of an omission or a misstatement of an item on the significance of the conclusions to be drawn from an entire report? What is "material" in a particular circumstance is, accordingly, a matter of judgment. A failure to record an expense of $100 for a firm whose net profits run into millions might not be significant, but an omission of the same amount for a concern whose profits run into the hundreds or a couple of thousands may be considered as significant.

In the first issue of its series of accounting research bulletins, the Committee on Accounting Procedure of the American Institute of Accountants pointed out that the pronouncements of the body would not be applicable to immaterial items. They wrote:

The committee contemplates that its pronouncements will have application only to items large enough to be material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. 42

The attention of the reader is invited to the underlined words in the following paragraph from the 1948 Statement of Concepts and Standards:


The effect on income taxes of an unusual item of revenue or expense should be disclosed whenever the effect is material. Similarly, disclosure should be also made of material tax consequences resulting from differences in financial and tax accounting.43

Concerning the doctrine of materiality, the following are typical statements appearing in the textbooks:

Accounting is not an exact science and there are many occasions when difference of treatment will lead to different answers, such as a different profit figure. Many of these differences, however, are slight and are not worth bothering about. Where the amounts involved are not material, the rule is to accept one reasonable figure and move on to more important things.

One of the most interesting proposals in line with the question of materiality has been to drop pennies from most accounting entries. Since many accounting values are estimates, why carry them beyond even dollar, or even hundred dollar, units?44

The very practical policy of materiality recognizes that precise accuracy in accounting may cost more than it is worth. As an example, a small tool costing $1.00 may last for ten years and, therefore, it would be correct to set it up as an asset and depreciate it at the rate of 10% a year. Obviously the cost of keeping such records would be unjustifiable, so a more sensible procedure would be to charge such a purchase directly to an expense account.45

A stimulator of much debate is the doctrine of conservatism, which advocates a central theme of caution in interpreting financial transactions and summarizing their results. It finds expression in such ideas


as "do not anticipate profits but provide for all losses." Supporters of the doctrine of conservatism consider it to be less of an evil to understate than overstate assets. Gilman points out some of the weaknesses of this concept:

There are serious objections to some applications of the doctrine of conservatism. The principal one and the most important is its effect upon comparative net profits. . . Any of the common methods of applying conservatism have a tendency to distort earnings so that during a period or several periods profits will appear unduly small, to be followed by a period or periods when the reverse effect is noticed. . . Just as depressions are followed by booms, so is accounting understatement bound to be followed by accounting overstatement, and vice versa.46

That part of the short-form audit certificate which states the financial statements present fairly the financial condition of a company and the results of its operations, "in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year," is indicative of the importance attached to the doctrine of consistency. Consistency implies that, where alternate accounting procedures are considered acceptable a particular method, once adopted will be followed from year to year, or, if there is a deviation from the established procedure, full disclosure will be made.

Concerning conservatism Sanders, Hatfield, and Moore state:

The common belief that less mischief is done by understatement than by overstatement is, in the hands of honest men, probably true; but with dishonest men understatement may serve their turn as well as overstatement.47


The following quotation points out the position taken by George May with regard to conservatism and consistency:

To me, conservatism is still the first virtue of accounting, and I am wholly unable to agree with those who would bar it from the books of account and statements prepared therefrom and would relegate it to footnotes.

Consistency is the second great virtue of accounting, and emphasis upon it in the form of auditor's reports that have been in use since 1932 is wholly desirable. However, accounting, like the common law, should have elements of flexibility and adaptability as well as stability. Therefore, there can be no absolute rule of consistency, but only a general admonition that consistency should normally be maintained, and a rule that any significant departure therefrom and its effects should be adequately disclosed.48

Below are discussions of the last two doctrines from a few leading textbooks:

Logical consistency is characteristic of most of accounting analysis and procedure. Once a method of calculation or a policy of handling a given situation has been adopted, it should be continued in use so that the results of one period can be compared with those of another. . .

One of the oldest and most influential doctrines in the field of accounting has been called 'conservatism.' It means that accountants have generally adopted the lower of any alternative asset valuation figures, that they have leaned over backward to make sure that all possible liabilities have been set up in the accounts, that they have been reluctant to recognize the earning of revenue until positive evidence of its existence was available, but that they have made early provision for all possible expenses and losses. 'Pessimism' would perhaps be a more descriptive term than 'conservatism.'49


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Conservatism, although desirable, is not a justification for the understatement of net worth and the misstatement of net income. Accounting reports must serve the requirements of investors as well as short-term creditors. Ultraconservatism may be prejudicial to the interests of stockholders or the holders of other securities who, having been led to believe that the company in which they have made investments is less prosperous than it really is, may sell their securities for less than they are really worth.

Departures from consistency should be disclosed. Changes in accounting procedures and valuation bases may have a material effect on balance sheets and income statements. For instance, assume that a company which has valued its inventories at cost decides to change to the more conservative basis of cost or market, whichever is lower; the change in basis may cause a material reduction in the stated profit for the period in which the change is made. Or a company which has regularly charged operations with a provision for bad debt losses may find that the reserve accumulated from prior provisions is adequate, and that no provision for the current period need be made. Although these two inconsistencies may be justifiable from the standpoint of accounting principles, the nature and amount of their effect upon the statements should be disclosed. (50)

Proper conservatism is a practice which can hardly be criticized. Accountants and businessmen have seen bad times as well as good. In a changing world, where bad times usually follow prosperity, where nothing is certain but uncertainty, a little caution is obviously not out of order. To be on the safe side of an estimate involving judgment provides a rock bottom foundation for an accounting report; any optimist who wishes to make liberal allowances or adjustments for his own purposes may thereafter proceed with the assurance that his point of departure is sound. (51)


Chapter IV
REVENUE AND INCOME

The next three chapters will be devoted to a consideration of accounting concepts of the nature of income, proposals relative to the influence of changing price levels on the determination of income, standards, and rules adopted for the determination of periodic income, and special problems of income accounting.

One of the most significant aspects of present-day financial reporting, and, likewise, one which has exerted a tremendous influence on accounting techniques, has been the shift of emphasis from the balance sheet or financial position statement to the income statement or statement of earnings. This change signifies the importance of income determination in the economic, industrial, and political life of the nation. Several significant developments in recent years have contributed to the increased emphasis on, and the necessity for the precise determination of net income. The first of these, which has been discussed in more detail in a previous chapter, is the widespread adoption of the corporate form of organization, characterized by the separation of ownership and control, the development of large-scale enterprises, and highly complicated and competitive business activities. Thousands of absentee-owners are obliged to depend upon reported earnings as an evidence of the efficiency of management and as a source
from which they may expect capital-returns in the form of dividends.
A second major influence is certainly the impact of taxes based upon
interpretations of income as established by the provisions of the
Internal Revenue Code. The rise of labor unions to a position where
their representatives have places at the bargaining table in wage
negotiations is still another factor. Among several others which
might be mentioned is the rapid development in the area of national
income statistics. Here statisticians and economists depend, in a
large measure, upon operating figures prepared by accountants as their
primary source of data for summarizing and presenting information with
regard to the state of the economy. In the words of the Study Group
on Business Income:

The growth in importance of income determinations
in the social and economic life of the nation is
a marked characteristic of the last half-century.
During the same period the increase in size and
complexity of business enterprises has made the
determination of business income more difficult,
and more essentially an accounting task.\textsuperscript{52}

The members of the Study Group on Business Income also report
that:

The Committee on Accounting Procedure of the Ameri­
can Institute of Accountants adopted in 1938 the
view that, 'A fair determination of income for suc­
cessive accounting periods is the most important
single purpose of general accounting reports of a
corporation.'\textsuperscript{53}

\textsuperscript{52}\textit{Changing Concepts of Business Income}, Report of Study Group on Busi­

\textsuperscript{53}\textit{Ibid.}, p. 19.
Sanders, Hatfield, and Moore express the same viewpoint as follows:

Making effective and effectively maintaining as near as may be the distinction between the capital and income of a particular enterprise are the ultimate objectives which determine the activities of accountants and the functions of accounting.\(^4\)

Paton and Littleton conceive of the accurate determination of business income as a means of directing capital funds into the most profitable uses. The following quotation describes this concept:

There is another way in which accounting is important from the social point of view. Capital should flow into those industries which serve the public interest, and within an industry into those enterprises in which the management is capable of using capital effectively. If capital in an enterprise is earning a return over a considerable period, this probably indicates that the capital is being capably employed in an industry serving an existing demand; if the capital is not earning a return over a period of time, this probably indicates that capital is lodged in incapable hands or in an industry whose service is not in continuing demand. The social importance of accounting therefore is clear, especially in relation to the income statement, since dependable information about earning power can be an important aid to the flow of capital into capable hands and away from unneeded industries.\(^5\)

Among the textbooks analyzed for this study, there appears to be a general agreement concerning the importance of the various aspects of income accounting. Some representative statements include the following:


\(^5\)W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 1940, American Accounting Association, p. 3.
Determination of income has come to be viewed by accountants as the leading question they must deal with. . . . the success of a business is judged primarily by its earnings, while the value of its assets is a secondary consideration. . . . The reporting of income is more, however, than a mere revelation of business achievement. It is a matter of life or death to the enterprise. If earnings are overestimated, the proprietors may be misled into withdrawing too heavily from the business, depleting its assets unduly. If income is underestimated, the proprietors may become discouraged and sell out, abandoning a business that is actually profitable. 56

Indeed, in the relatively modern phase of accountancy, accountants have passed through the stages where the emphasis in their work has shifted successively from the simple accounting, indicating a proper discharge of stewardship, to the balance sheet or record of assets, liabilities, and proprietary interest, and finally to the income statement involving the accurate determination of net income as well as the measurement and control of operating effectiveness. 57

Nature of Income and Revenue

There is still quite a bit of confusion in terminology with respect to such items as income, revenue, net income, and net profit. In much of current writings on the subject, no distinction is made between income and revenue, while other writers interpret revenue to mean gross income and net income to be the final profit or gain figure. The latter interpretation will be used in the following discussion.


with specific attention directed to what meaning is intended, if it is felt necessary for clarification.

In his study of accounting concepts of income Bedford sought to answer the following questions:

1. What is income?
2. Whose income should be reported?
3. When should income be recognized? 58

With respect to an examination of the 1948 Revision of Concepts and Standards Underlying Corporate Financial Statements by the American Accounting Association, Bedford draws the following conclusions concerning the accountants' concept of the nature of income:

a. Accountants imply at times that all gains in ability to satisfy human wants are reported but attempt to report only a portion of the gains.

b. Accountants sometimes endeavor to measure in terms of money the gain in ability to satisfy human wants. At other times accountants report a gain of money as income when there is little evidence that a gain of money measures a gain in ability to satisfy human wants. 59

From his study of the bulletins of the American Institute of Accountants, Bedford reports the following concept of income:

a. Accountants generally report a money or its equivalent type of income but at times attempt to report a gain or rights in property as income.

b. Accountants generally report money or its equivalent as income but do not report all of it as income. 60

59 Ibid., p. 527.
60 Ibid., p. 532.
In their exhaustive investigation, the Study Group on Business Income found significant variations in use and interpretation of the term income in law, finance, business, economics, and accounting. Though they have been cautious about defining income, they appear to place general reliance on the interpretation as given by the Supreme Court as "gain derived from capital, from labor, or from both combined." The Study Group reported that the "English courts have consistently held that what was business income was, in the absence of specific provisions of law to the contrary, to be determined by business practice."61

In one of the summary statements on concepts of income, the Study Group makes the following observation:

The facts that income exists only by definition, that in common use the word is employed in materially different senses, and that the 'income' for a given period may properly vary with the purposes or entity for which it is being determined, make it desirable that the word should be used with a qualification or explanation which will indicate the purpose and viewpoint clearly.62

In Section 8 of its report under the heading, "Summary and Conclusions," the members of the Study Group state:

In law and accounting there is agreement that business income is in general realized gain, that is, the gain derived from realized revenues; what constitutes realization, and what exceptions, if any, to the general view should be recognized may be regarded as problems of implementation. Economists might disagree with the


62 Ibid., pp. 15-16.
accounting view; accountants might agree with the economists that a gradual recognition of revenues on the basis of accretion might be theoretically preferable, but they might reject it as too seldom capable of implementation. 63

Paton and Littleton make this distinction between revenue and income:

Revenue is the product of the enterprise, measured by the amount of new assets, received from customers; income emerges when the assets which express revenue exceed the total of assignable costs. 64

From the American Accounting Association 1948 statement comes the following discussion of the two terms:

The income of an enterprise is the increase in its net assets (assets less liabilities) measured by the excess of revenue over expense. The income of a corporation is not affected by the issuance, acquisition, or retirement of the corporation's own capital shares, adjustments of stockholders' interests, or dividend distributions by the corporation.

Revenue is a generic term for the amount of assets received or liabilities liquidated in the sale of the products or services of an enterprise, (b) the gain from sales or exchanges of assets other than stock in trade, and (c) the gain from advantageous settlements of liabilities. Revenue does not arise from a gift.

Revenue is recognized upon the transfer of an asset, the performance of a service, or the use of a resource of the enterprise by another party, accompanied by a concurrent acquisition of an asset or a reduction of a liability. 65


64 W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 1940, American Accounting Association, p. 46.

65 Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948 Revision, American Accounting Association, p. 3.
There seems to be general agreement among authors of textbooks as to the nature of the accountant's concept of income. The following expressions indicate the type of the presentations made on this matter:

To some accountants the term revenue means the gross proceeds from sales and services; to others it means the excess of the gross proceeds over the related costs. We shall consider the word revenue to mean an inflow of assets, but it must be recognized that there are inflows of assets which are not revenue. Obviously, an inflow of capital funds from stockholders is not revenue to a corporation, nor should a business regard as revenue an inflow of assets which is offset by an increase in liabilities. Increases in the value of assets resulting from growth, natural increase, or a rise in market prices are not revenue. Revenue consists of an inflow of assets from customers and clients, and is related to sales and the rendering of services.66

'Revenue' is the accounting term for the amount of assets received in exchange for the products and services sold to customers by an organization.67

Gross income is earned at the time when an enforceable property right is created against a legal person through his receipt of contractual consideration. The earning of a gross income, however, does not necessarily mean that cash has been collected. It signifies only that, because of a consideration delivered, another consideration has been received or that the right to receive a consideration has been created.68

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Income measures all wealth which flows into the enterprise other than an investment, a mere return of capital or investment, or gift.®®

Timing of Revenue Recognition

Once a satisfactory interpretation of the nature of revenue or income has been developed, another problem immediately presents itself: When is the appropriate time for recognizing revenue? When is revenue realized? A review of current literature in accounting reveals considerable agreement on this phase of income accounting. Bedford makes the following comment:

It is possible conceptually to recognize revenue in at least the following times:

1. Simultaneous with production and distribution efforts.
2. At the legal sale date.
3. At the disposition date of goods and services.
4. At the time cash is collected. 70

From his examination of the AAA Statement, he concludes that with respect to when income should be recognized:

a. Accountants state that revenue is to be recognized at the disposition date of property but revert to the cash receipts date under certain circumstances. . ..

. . . .

d. Accountants insist on objective evidence before either revenue or expense or loss are to be recognized but, nevertheless, they do use considerable subjective evidence. 71

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71Ibid.
A COMPARISON OF ACCOUNTING CONCEPTS AND STANDARDS EXPRESSED IN
A SELECTED GROUP OF COLLEGE TEXTBOOKS
WITH OTHER CURRENT LITERATURE

Chapter I

Nature, Scope, and Importance of the Study

Scope of Study

This study is primarily concerned with examining the major concepts, standards, rules, and procedures of accounting as presented in a selected group of college textbooks in order: (1) to ascertain the underlying theories which serve as the framework for the application of modern accounting techniques; (2) to determine the degree of agreement among authors of the textbooks concerning the controversial accounting problems which have been created by the complexities of large-scale business operations; and (3) to compare the views expressed by the authors with those advocated in other current literature by academic and professional writers.

Significance of the Study

Accounting may be defined as the science and the art of systematically recording, presenting, and interpreting the financial facts of the activities of an individual or enterprise. The need for keeping records from which periodic reports of business activity could be obtained was recognized early in the history of man's commercial efforts. When business enterprises were operated along simple lines, with the one-owner type predominant, only crude, make-shift records were necessary. Records were primarily kept by the owner, or for the use of the owner, in order
His analysis of the AIA bulletins reveals that:

a. Accountants recognize revenue at the sales date, collection date, and construction date but are not consistent as when each should be used.\textsuperscript{72}

The production theory of income realization supports the viewpoint that the act of producing salable goods results in income which should be reflected in the accounting records. This concept considers the recognition of income as emerging at the instant of sale as unrealistic, conceiving the creation of income as a steady flow throughout the process of getting goods ready for sale. There is no general support for this type of revenue recognition, either in the college textbooks or other contemporary literature.

Gilman writes:

Because recognition of income on production basis appears reasonable for companies to which ready markets are available, scarcely seems a valid argument for their adoption of a different accounting convention. This seems particularly true since the production theory generally applied to all economic units would be ridiculous for many of them while the realization test, if applied to all, would result in no practical disadvantage to any.\textsuperscript{73}

A number of significant comments are made by Paton and Littleton on this issue:

Revenue as the price-aggregates of output sold does not appear full-fledged until the product is completed and the selling price determined by actual sale. . .


Earning must not be confused with realization. Revenue is realized according to the dominant view, when it is evidenced by cash receipts or receivables, or other new liquid assets. Implicit here are two tests: (1) conversion through legal sale or similar process; (2) validation through the acquisition of liquid assets.

As a basis for revenue recognition in the accounts, realization is in general more important than the process of earning. It is one thing to say that revenue is earned as the result of the entire process of production; it is quite another to hold that revenue can be measured and recognized prior to completion and disposition of the product.

... There are special conditions under which a variation from the sale-standard is often considered acceptable because the revenue can be measured with some assurance on a production basis.

In the case, for example, of production to order, at an agreed price, the uncertainty as to the final amount is largely eliminated and it is possible to derive acceptable estimates of revenue from accumulated cost figures as the work progresses.74

The Committee on Accounting Procedure of the American Institute of Accountants in its first of a series of accounting bulletins maintains that:

Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured.75


The same viewpoint is expressed by the Committee on Concepts and Standards of the American Accounting Association:

The usual criteria for the recognition of revenue are subject to modification where there is an extended period of collection or where related expense of substantial amount is to be incurred after the date of sale. 76

In general, the textbook treatment of the problems associated with the timing of income recognition is adequate and is in harmony with existing practices and standards as outlined above.

Tunick and Saxe make the following presentation:

Revenue is realized when the transaction is firmly completed by valid sale or otherwise, and realized upon through the acquisition of dependably collectible assets by the vendor. The installment sale furnishes a familiar example of revenue not regarded as realized, except when collected in cash. Neither unrealized appreciation in capital assets nor the unrealized accretion in value resulting from growth or other natural processes is recognized as revenue, under this standard. Variations from this standard are permitted, however, in the case of long-term construction or cost-plus types of contracts. 77

Concerning the production basis of income measurement, Finney writes:

But revenues are sometimes regarded as earned before a sale is completed, if the realization of an asset increment is reasonably assured. For instance, if goods are manufactured under a cost-plus contract and the amounts of revenue applicable to completed portions of the contract are determinable, realization of revenue may be


reasonably assured even though delivery and transfer of title have not been made. The taking up of profits on fixed-price contracts in process is of doubtful propriety, because completion costs usually cannot be estimated with accuracy; therefore, there is no certainty regarding an ultimate profit. In other words, an asset increment is not reasonably assured. 78

The writer believes that an ideal type of textbook presentation of the realization of revenue is that by Mason, Stenberg, and Niven, quotations from which are presented below:

Revenue Earned when Cash is Received. The simplest case is the service enterprise which does business on a cash basis. . . The furnishing of the service and the final settlement by the customer with a cash payment occur almost simultaneously and the amount of cash received each day can be taken as an accurate measure of earned revenue. . .

Revenue Earned after Cash is Received. The receipt of cash may sometimes precede the furnishing of goods or services. . . In instances such as these the rendering of the service or the delivery of goods, not the receipt of cash, is usually considered the appropriate event which justifies the recognition of earned revenue. . .

Revenue Earned before Cash is Received. The receipt of cash after the rendering of the service or the delivery of goods is a very common occurrence. . . the sale is the usual basis for revenue realization in 'trading' concerns where it is the function of the business to buy goods and sell them, if possible, at a profit. . .

Earned Revenue Based upon Production. The production or manufacture of goods 'for stock,' that is, where sales effort must be made in order to dispose of the goods after they are produced, is rarely thought to be a step which justifies the recognition of earned revenue. . . An exception is sometimes made, however, when

the sales activity is incidental and merely requires the delivery of the goods to a well-established market. Gold mining is a classic example. . . Production on special order, such as construction work or the making of special machinery, also presents a good case for revenue realization on the basis of production since the sales contract has, in this case, been made prior to production. . .

**Accretion as Revenue.** Accretion—the increase in value of assets caused by physical growth or natural increase—is not usually considered to be recognizable revenue. . . It is common practice, however, to recognize as revenue the natural increase in livestock in farming operations. . .

**Appreciation.** An increase in value of assets due to such general economic factors as rising price levels or changing costs of production, commonly known as 'appreciation', is not usually treated as earned revenue. . . When speculation in commodities or securities is the principal function of a business, price changes are of primary importance and may legitimately be used as the basis of income determination, even though no actual sales have taken place. . .

**Accrual of Revenue.** Revenue may be recorded because it has accumulated, or accrued with the passage of time. Revenue arising by the accrual process conforms to the conception of revenue as a charge for services rendered. . . Rent revenue is earned as the claim against the tenant increases by the passing of time during which the tenant has had the use of the property.

**Revenue from Exchanges.** It is sometimes urged that no income is realized from an exchange of property, as when one vacant lot is exchanged for another. Such an interpretation may not be unreasonable in isolated transactions where no better basis is available for analyzing the situation, but in general it would be better to treat the exchange as a sale, with the recognition of any profit or loss, followed by a purchase. The revenue realized from the sale would be the market value of the property acquired. 79

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In Chapter II, one of the basic concepts of accounting—the assumption of a stable monetary unit—was discussed. It cannot be denied that accountants, economists, business men, and the general public are aware that this is not a valid assumption. History reveals fluctuations of the dollar in terms of real purchasing power in period after period. But, until a few years ago, the accountant felt safe in ignoring this fact in his calculations of periodic income. However, the last few years have been characterized by steadily rising prices throughout the economy which have brought sharp and frequent challenges of traditional methods of income accounting.

Professor Murphy points out how several large companies handled the problem of higher price levels in their financial statements issued in 1947. The United States Steel Corporation placed in its earnings statement an extra charge for depreciation in order to recognize the difference between replacement cost and actual cost of the fixed assets of the company. According to Professor Murphy, E. I. du Pont de Nemours & Company charged against its 1947 income a provision amounting to approximately 17 per cent of its reported net income,

80 Mary E. Murphy, Selected Readings in Accounting and Auditing, New York: Prentice-Hall, Inc., 1952, p. 255.
for excessive construction costs of productive facilities. Also, in the same year Chrysler Corporation is said to have increased depreciation charges by an amount somewhat less than 8 per cent of reported net income, for a similar purpose. In the first two cases, the independent auditors qualified their certificates, while in the case of the Chrysler Corporation, the auditors made full disclosure without qualification.

Two schools of thought have developed around this controversial issue of what to do about changing values of the dollar in accounting for business income. In recent years there has been a flood of literature and public discussion regarding the subject.

It was natural for the problem to develop in connection with methods of accounting for the expiration of fixed asset costs. The traditional method of measuring income is by considering the excess of dollar revenue over historical dollar costs. On one hand, almost all revenues are received in current dollars, whereas, on the other hand, costs represent a conglomerate of expenditures of current and past years, and sometimes future years. Because of the rather rapid turnover of current assets, the effect of changing price levels may be slight, but, in the eyes of many, it is in fixed asset accounting that the problem becomes important.

Because of the widespread debate concerning the problem, the Study Group on Business Income made its special investigation. They list the three specific questions which they set out to study as follows:

Is LIFO accounting, as now applied, only a reasonable assumption as to the actual flow of goods and costs, or more broadly, a means of bringing costs
into account on approximately the same price
level as revenues?. . .

Should accounting procedures be revised so as
to bring cost of property exhaustion into ac­
count at approximately the same price level as
the revenues and, if so, how should this object
be accomplished? . . .

Assuming social usefulness to be the objective,
should the situation be met by (1) changes in
methods of accounting (2) changes in methods of
presentation, or (3) supplementary information? 81

To show the extent of fluctuations in the value of the dollar,
the members of the Study Group report that:

Statistics prepared for the Group show that
between 1938 and 1948 the wholesale price level
rose rather more than 100 per cent, and that
during the last two hundred years the value of
the dollar at its highest point in any quarter-
century was from 1.3 to 3 times its value at
the lowest point in the same quarter-century.
Manifestly, annual accounts do not attain maxi­
mum significance so long as such fluctuations
are ignored in their preparation.82

From its investigation, the Study Group was able to discern the
existence of three schools of thought among accountants, as illustrated
by the following quotations:

Those who have favored adherence to present
practice have commonly talked in terms of 'fac­
tual' and 'objective' determinations and 'uni­
formity'. . . They take the view that financial
accounts are primarily reports of stewardship
and that the obligation of management is to
account for the monetary capital invested in
the corporation. . .

81 Changing Concepts of Business Income, Report of Study Group on Busi­

82 Ibid., p. 49.
Members of the second group, taking a broader view of the character of the financial accounts, have urged that the monetary unit should be regarded as a tool to be used by the accountant with full recognition of its uses and its defects. They would have accountants take cognizance of the fact that the design of the tool is changed from time to time by its makers (Government) and that those who fashion it may seek to impart to it not stability, but a purposeful instability of purchasing power. They, therefore, believe that the efforts of accountants should be directed to presenting determinations of income in which revenue and charges against revenue would be stated as nearly as possible in units of the same purchasing power. They recognize that marked changes in the value of money create other problems which affect the balance sheet and call for consideration.

The members of a third group, while they did not favor taking cognizance of fluctuations in the value of the monetary unit in general, have felt that in the recent past the changes have been so great that they should be recognized through a general restatement of carrying values of the tangible assets of corporations; this they suggest would restore to the balance sheet a significance which does not now exist.

Arguments in Favor of Change

In order to point out the principal arguments which have been advanced to modify present methods of accounting so as to reveal the effects of changing price levels, a few statements on the subject which have appeared in current literature will be examined. Broad points out that one of the major effects of inflation upon accounting "has been to raise the question as to what is cost and whether past costs incurred at a time when the purchasing power of the dollar was substantially

higher than it is today should be treated as the equivalent of costs incurred in current dollars.84

The following expressions indicate the nature of Broad's thinking on the general topic of which method of accounting would be most useful—the traditional or the adoption of techniques to take account of inflation:

The economist... is concerned with gross national product, savings, investment, the division of gross business income among the various claimants, and the like, and his concern is with real, not monetary, earnings, and capital...

The investor is interested in the continued soundness of the business and its prospects of increasing or at least maintaining its earning capacity. If income includes capital gains or other extraneous elements not representing profits from operations he would wish to be so informed...

Continued taxation of capital, in whatever garb disguised, could have disastrous long-range effects. If it is happening, accounting must seek to portray it... There has been a great deal of discussion of the effect of taxing as ordinary income gains which are primarily the result of increases in the price of goods of property where these must be replaced at the higher prices. The results are so clear that only passing mention need to be made of them.85

A more definite position on the issue is summarized in the following statement by Broad:

It seems clear from what has been said that inflation does have a substantial bearing on costs and profits reported. Due to the emphasis on monetary capital as distinct from real capital which pervades accounting practice, these effects are substantially ignored in financial statements. As accountants we express our


85 Ibid., pp. 302-303.
to guide him in the management of the enterprise. The passing of time witnessed the development of more complex and widespread business endeavors, with numerous owners, operating in a highly competitive business environment. The necessity for accurate record-keeping and the presentation of financial information, both to owners and to those outside of the enterprise, increased thousand-fold the importance of accounting.

A number of factors have contributed to the increased reliance on accounting as an indispensable tool in the conduct of modern business establishments. Perhaps the most important of these has been the development of large-scale business units. The tremendous size of some of these undertakings makes it impossible for management to keep in personal touch with the many varied phases of the operations. Thus, those responsible for directing the activities of the companies are obliged to depend upon accounting records and reports to supply the essential information necessary for promoting the growth of the organization and reporting to shareholders. Those absentee-owners, scattered far and near, who have no direct hand in the day-to-day operation of firm activities, must place reliance on accounting reports for their knowledge of the stewardship of management, to whom they have entrusted capital funds. It is in this role that accounting assumes tremendous social responsibilities. The splitting up of capital contributions into numerous units in the form of shares or bonds makes the greatest possible precision in the determination of periodic income and financial condition imperative as a means of preserving equity among the various parties and groups.

Another important factor which has added immeasurably to the influence of accounting and the necessity for accurate, uniform standards, is
opinion that the financial statements present fairly the results of operations in accordance with generally accepted accounting principles and there is no doubt as to the truth of the statement so far as it goes. It is the truth but not the whole truth. With the substantial decline in the purchasing power of the dollar which has occurred since 1939 a question arises whether we have not reached a point where we should tell more of the truth; whether for many purposes for which financial statements are prepared their usefulness would not be enhanced by giving some indication of the effect of inflation where it is material.\(^6^6\)

Even if there were general agreement as to the necessity for modifications of accounting techniques to show the effect of changing price levels, another problem would be the adoption of a method to accomplish it. Kane points out that in considering methods of offsetting price changes, there must be a recognition that these changes may occur in two dominant ways. He comments:

> There is reason to believe that the difficulties which we have encountered are due in part to a failure to clearly define the problem. Specifically, there has usually been a failure to distinguish between a change in the structure of prices and a change in the general price level. A change in the structure of prices of other goods and services, with, therefore, a change in the real economic value of both sets of goods and services. A change in the general price level involves only a proportional change in the prices of all goods and services. If there is a change only in the general price level, this does not in itself imply a change in the value of any good or service, but does imply a change in the value of money and of obligations expressed in terms of a certain amount of money.\(^6^7\)


Making the observation that in an actual situation, it is likely that there will be changes both in relative prices and in the general level of prices, Kane indicates that the accountant must decide whether he is trying to adjust for one or the other of the changes, or both. He believes that business executives are most concerned with making adjustments for changes in the general purchasing power of the dollar, rather than for changes in the real value of particular assets. The former can be done by the use of a general purchasing power index. Kane further states:

And from the standpoint of accountants, statements which are adjusted only for changes in the general purchasing power of the dollar would not in a real sense constitute a departure from a historical cost basis of accounting, and would, therefore, not involve the lack of objectivity which follows from the adoption of a value basis of accounting. Also the commonly employed test of income realization is compatible with the concept of adjusting only for changes in the general purchasing power of the dollar.  

There appears to be widespread agreement among accountants that one means of accomplishing the objective of adjustment for changing price levels would be through the use of index numbers. Among the problems which have to be answered with regard to the appropriateness of this method of adjustment are: What type of price index should be used—general prices, or specific? What base year should be adopted? What items should be adjusted? 

A number of objections to the use of index numbers in accounting have been advanced. Bowers has pointed out the major objections which

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have appeared and after critically examining them arrives at the conclusion that they are not very valid. The principal arguments advanced against their use which he analyzes and disputes are:

(1) Index numbers are not accurate. No index should be used as a matter of principle because an index is only a statistical average which cannot be applied to individual cases such as particular firms.

(2) There are so many indexes for various price situations that it is not possible to determine which index ought to be used.

(3) The use of index numbers attempts to measure purchasing power and the conversion of transaction costs or receipts by the use of such numbers does not create or destroy actual purchasing power.

(4) Profit is the difference between cost and revenue and the recognition of an element of gain or loss resulting from the use of index numbers would obscure the true results of managerial skill by confusing the results of managerial decisions with general price movements.

(5) It is too difficult to reconcile the results of index number accounting with established legal principles especially as regards taxation and the distribution of profits.

(6) The accountant's statement is only an imperfect projection of reality at best; and there is no use in making it seem more complicated and less intelligible than at present.

(7) The information provided would be of little use to anyone.89

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Bowers makes a detailed study of each objection and seeks to refute each, finally stating:

In conclusion it would seem that the valid objections to the application of index numbers to accounting data for purposes of reporting profits and losses are few. Unless the general price level remains constant, better index numbers should be constructed. An index designed to measure the change in general purchasing power of the dollar is superior for this purpose to any more special index. The index ideally might be one based on all commodities, or it might be one based on the prices of consumer's goods. People do think in terms index numbers during times of substantial price changes. Formal reports of profits based on carefully constructed indexes give more accurate results than the use of no index in a formal sense at all. The use of index numbers gives recognition to the economic realities of a business situation in place of mere legal formality where legal dollars are assumed to have a constant purchasing power.

In an article under the title, "The Case Against Price-Level Adjustments in Income Determination," Wilcox and Greer have presented strong arguments against any change in the traditional accounting methods. Their first attack is against the replacement-fund theory, which holds that income should be charged with amounts sufficient to replace assets at the end of their useful life. One of the fallacies of such a concept, they point out, is that assets are seldom replaced in kind, but by much more efficient and economical types, whose added productivity often offsets any increases in cost. This is due to the highly technical nature of the economy, which is always devising new


products or new ways of doing things. Another argument against the replacement-fund theory is that an era of low prices following one of high prices might mean that income is charged with amounts in excess of that needed to replace existing plant. Finally, it is concluded that most accountants have given up this concept for the adoption of some index method of showing price changes. However, Wilcox and Greer indicate that they have no faith in the reliability of index numbers in the following comments:

General price indexes are statistical averages, and statistics are dangerous. They have been known to bite the hand that made them. The introduction of statistical-average adjustments into accounting requires that accountants become expert statisticians, and it seems likely that if they did, they would realize the dangers of this field clearly enough to refuse to mix it with accounting. Statistical averages refer to the characteristics of groups, not individuals; they are weighted; they have meaning only in relation to a measure of dispersion and of error or deviation. The wider the dispersion, the less meaning there is to the average. All this is a part of the science of statistics which is a field in itself, and experts in that field are constantly warning themselves and others against drawing unwarranted conclusions from statistical averages.92

Concerning the reflection of price changes in the accounts as a means of obtaining tax relief, Wilcox and Greer deny that there is any advantage because the allowance of larger deductions would probably necessitate higher income tax rates in order to assure the government its desired income. With regard to the belief that price-level

adjustments would be socially beneficial, they state:

Price-level adjustments in income determination are sometimes urged on the broad grounds of desirable social effects. It is urged that inclusion of the effects of price-level changes results in overstatement of income in times of rising prices and understatement in times of falling prices, thus augmenting the psychological forces behind booms and depressions. . . It is arguable with at least equal force, that an upward adjustment of costs during times of rising prices would have the psychological effect of inducing producers to raise their prices, thus actually contributing to the swing of the pendulum. Guesses at psychological reactions are a far cry from income determination.93

The following are examples of statements from writers who argue against any attempts to incorporate price-level effects in financial statements:

. . . The art of accounting has always been applied on the assumption of a relatively stable value of the dollar because to do otherwise and cut loose from the moorings of historical cost would open up a Pandora's box of confusions, annual appraisals, complications and adjustments to recorded dollar values which would be a far greater evil than the one now prevailing, since objective measurements beginning with the historical cost of fixed assets would be cast aside and be superseded by subjective measurements, that is, by periodical appraisals of present values according to fluctuating value of the dollar. This would require annual appraisals and inject a variability and uncertainty into the annual determinations of corporate income to even a far greater degree than that which prevails today.94


Some suspect that the relative importance of depreciation in the financial statements is being overemphasized. Material, labor, and most of the manufacturing expenses except depreciation are sensitive to changes in the value of the monetary unit. In manufacturing and mercantile concerns, labor and materials alone usually constitute the major portion of charges to cost of sales. When one finds a heavy proportion of fixed assets to total assets, almost invariably he also finds funded debt for a significant portion of these fixed assets among the liabilities. The amount of this debt is a fixed dollar volume, and if the value of the dollar declines, the company in effect realizes income both at the time of interest payments and the maturity of the debt. Such 'income' will tend to offset the 'loss' suffered because of the price increase for the portion of the assets purchased with borrowed money. In other words, these two items, almost always found together, tend to offset one another in the vaguely defined concept of 'economic income.' This is true of any enterprise which finances a portion of its operations by the issuance of bonds.

In Which Direction?

What appears to be the outgrowth of the pro and con discussion concerning the task of accountants in the matter under discussion?

The trend seems to be an extension of the accountant's responsibility in the area of preparing primary financial statements of supplementary statements in such a way that readers may be made aware of the effects of price-level changes on the earnings picture and financial condition and to be better guided in making decisions thereon. This is evidenced by conclusions which have been reached by the AIA Study Group and the AAA Committee on Concepts and Standards.

Conclusions of the Study Group are summarized in the following statements:

... It would seem that in the longer view methods could, and should, be developed whereby the framework of accounting would be expanded so that the results of activities, measured in units of equal purchasing power, and the effects of changes in value of the monetary unit would be reflected separately in an integrated presentation which would also produce statements of financial position more broadly meaningful than the orthodox balance sheet of today. It is believed that statements of business income in which revenues and charges against revenue would be stated in units of substantially the same purchasing power would be significant and useful for many of the purposes for which income determinations are commonly used, if not also in reports upon stewardship...

For the present, it may well be that the primary statements of income should continue to be made on bases now commonly accepted. But corporations whose ownership is widely distributed should be encouraged to furnish information that will facilitate the determination of income measured in units of approximately equal purchasing power, and to provide such information wherever it is practicable to do so as part of the material upon which the independent accountant expresses his opinion.

After a thorough examination of the problem at issue, the Committee on Concepts and Standards of the American Accounting Association issued a statement entitled, "Price Level Changes and Financial Statements." Their conclusions, which are very similar to those of the Study Group, may be taken as a rather accurate picture of where we stand today:

(1) In periodic reports to stockholders, the primary financial statements, prepared by management and verified by an independent accountant, should, at the present stage of accounting development, continue to reflect historical dollar costs.

(2) There is reason for believing that knowledge of the effects of the changing value of the dollar upon financial position and operating results may be useful information, if a practical and substantially uniform method of measurement and disclosure can be developed.

(3) The accounting effects of the changing value of the dollar should be made the subject of intensive research and experimentation; the specific significance of the basic problem should be determined with as much accuracy as possible; the means of its solution, if its significance warrants, should be thoroughly investigated...

(4) The effects of price fluctuations upon financial reports should be measured in terms of the overall purchasing power of the dollar—that is, changes in the general price level as measured by a general price index. For this purpose, adjustments should not be based on either the current value or the replacement costs of specific types of capital consumed.

(5) The measurement of price level changes should be all-inclusive; all statement items affected should be adjusted in a consistent manner...

(6) Management may properly include in periodic reports to stockholders, comprehensive supplementary statements which present the effects of the fluctuation in the value of the dollar upon net income and upon financial position.

(a) Such supplementary statements should be internally consistent; the income statement and the balance sheet should both
be adjusted by the same procedures, so that the figures in such complementary statements are coordinate and have the same relative significance.

(b) Such supplementary statements should be reconciled in detail with the primary statements reflecting unadjusted original dollar costs, and should be regarded as an extension or elaboration of the primary statements rather than as a departure therefrom.

(c) Such supplementary statements should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the adjusted data.97

Opinions Expressed in Textbooks

This writer did not expect to find much discussion concerning the effects of changing price levels on the determination of income in the textbooks examined because the greatest development along that issue has been within the last four or five years. In general the writers touched upon the matter in discussing appreciation of fixed assets or the stable monetary convention. Most of them conclude, in line with traditional accounting methods, that variations in the value of the dollar can be ignored for accounting purposes.

On the other hand, there were a few textbooks in which were rather detailed discussions of the problem. Two authors, Ascher and Paton, saw fit to point out ways which might be adopted to make adjustments

the steadily increasing control and regulation of private enterprise by state and national governments. Foremost in this area has been the rapid increase in business taxation, demanding more and more record-keeping in order to comply with the various tax laws. Increasingly, businesses are being subjected to more public control. This is especially true in the case of utility regulation, in which accounting reports must be utilized to furnish much of the information needed by the supervising agencies. Uniform systems of accounts have been prescribed by the regulatory bodies. In the marketing and distribution of corporate securities, the work of the Securities and Exchange Commission and state commissions has also placed emphasis on the development of accounting standards.

The rapid growth of labor unions to a position of power in America's industrial life has created still another demand on accounting, which has the responsibility for providing information to serve as a basis for difficult management-labor wage decisions. Current controversies with respect to fair wages frequently hinge upon a firm's ability to pay as revealed by its accounting records, which themselves may be subject to review by employee representatives.

The above paragraphs point out in a brief way the great social responsibilities now assumed by those engaged in the task of recording and summarizing financial information. In the era of small business endeavors the records were principally for the use of managers and owners who were on the scene daily directing the enterprise. Since the records were mainly for their use, they were adapted to the needs of the individual situation. Their personal judgments as to the propriety of certain
if desired. The following are typical statements from Ascher's book:

... Accounting records and accounting reports can be seriously impaired, even invalidated, by the changes that occur in the purchasing power of the dollar.

... Profits may be affected because costs rise (or fall) at one rate and revenues at another.

... Accounting estimates may also be seriously affected by the changing price levels through the changing value of inventories.

... Rising prices may increase the need for working capital, while falling prices may decrease the requirements.

... Inflation and deflation may also do strange things to the receivables and payables, particularly if the change in prices is rapid. A note receivable with a nominal value of $1,000 may be worth only $500 in purchasing power if prices double before maturity date. On the other hand, a liability may be much more burdensome if prices fall (prices of the company's product) before the debt can be paid off.

... Changes in the price level also have an important bearing upon the price of fixed assets and the depreciation that is based upon the cost of these assets. Assets bought during low price periods lead to modest depreciation charges for many years to come, while equipment and facilities acquired during boom times may result in high depreciation charges for the long years that these high-priced assets will remain in service.98

Continuing his discussion of the problem of changing price levels, Ascher points out several methods which have or may be adopted to make

the adjustments. These include the use of index numbers, the LIFO method of inventory valuation, increase in depreciation charges, and appropriation of surplus to offset effects of inflation. The most unusual device described in Ascher's book is a four-column journal, which would make use of debit and credit columns for the money of the moment and another pair of debits and credits in terms of pre-inflation money. This system enables accounting reports to be prepared either in terms of current dollars or "deflated" or constant dollars.

In one of his textbooks, Paton devotes a chapter to the problem at issue under the title "Common-Dollar Reporting." He believes that:

The use of an elaborate system of supplementary accounts through which an attempt is made to revise in each entry in the records at short intervals in terms of weekly or even monthly price indexes is probably seldom if ever expedient. What is needed is a special report supplementing the periodic statements, particularly when in comparative form, designed to trace the main effects of general price movements upon the affairs of the enterprise. Further, except in periods where the change in dollar value is sharp and prolonged as a result of emergency conditions and accompanying monetary tinkering, the case for giving detailed attention to the problem is not very strong.99

Under the chapter heading, "Tangible Fixed Assets," Finney and Miller100 present the pros and cons of the dilemma of what to do about


changing price levels in the accounts. It is noticeable that they refrain from expressing personal views to any extent but, instead, present good summaries of the case for both sides. As previously stated, what other writers had to say on the problem was generally discussed in chapters dealing with fixed assets with regard to the problem of appreciation. For the most part, they held to the viewpoint that appreciation should not be recognized in the accounts. However, they would show ways by which it could be done. Also, they generally adhered to the viewpoint that if higher values were placed on the assets subsequent depreciation allowances should be based upon such higher values.
Chapter VI
STANDARDS FOR THE DETERMINATION OF NET INCOME

In accordance with the major purpose as set forth in the introductory chapter, this study is restricted to an analysis of the principal concepts and standards of accounting as revealed in contemporary literature. Thus, there will not be a detailed discussion of every rule, procedure, or technique that is used by accountants. It may be said that with regard to the determination of net income a large number of such rules are practiced. In this chapter are set forth the general principles which have found wide favor in the college textbooks and other current literature, with only a limited sampling of how they are actually applied.

Matching Income and Expenses

One concept which appears frequently in accounting literature is the so-called matching of costs and revenues in the determination of periodic income. In its most theoretical and ideal form, each item of realized revenue would have charged against it the costs which were incurred to produce it. Net profit, or net income, would then emerge as the excess of the revenue over the assigned costs. Paton and Littleton view this process as one of measuring effort, as reflected
by costs, with accomplishments, as reflected by revenues. They state:

With acquisition and disposition prices measuring both the efforts to produce results and the results produced, the principal concern of accounting is the periodic matching of costs and revenues as a test-reading by which to gauge the effect of the efforts expended.\footnote{W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards, 1940, American Accounting Association, p. 7.}

They admit that the ideal type of matching process indicated in the above quotation falls far short of perfect accomplishment in practice. This is expressed in the following comments:

Ideally, all costs incurred should be viewed as ultimately clinging to definite items of goods sold or service rendered. . . Not all costs attach in a discernible manner, and this fact forces the accountant to fall back upon a time-period as the unit for associating certain expenses with certain revenues. Time periods are a convenience, a substitute, but the fundamental concept is unchanged. The ideal is to match costs incurred with the effects attributable to or significantly related to such costs.\footnote{Ibid., p. 15.}

Without using the terms "matching," "costs" or "revenues," Bray makes use of more descriptive language to indicate what the accountant does in measuring income. His comment follows:

We may hope that by now we have said enough to show that the accounting measurement of the operating profit of a business enterprise is definable in terms of its current operating incomings derived from the monetary claims accruing in respect of the goods which it has delivered and the services which it has rendered over a given space of time, less its...
current operating outgoings conceived as the monetary claims which it has incurred in respect of goods received by delivery and services rendered in furtherance of its purposes during the same period of time, less its current operating outgoings conceived as the monetary claims which it has incurred in respect of goods received by delivery and services rendered in furtherance of its purposes during the same period of account, together with appropriate adjustments for proportionate allocations of long-term outgoings and inventories of current operating outgoings not immediately capable of association with the ascertainment. 103

There is considerable criticism of the matching process, either from the standpoint of its usefulness as a standard for income accounting or from the standpoint that it does not represent what accountants actually do. In the words of the Study Group:

Only in part are costs 'matched' against revenues, and 'matching' gives an inadequate indication of what is actually done. One defect of the statement is that it obscures essential differences in the nature of the various charges that must be met out of revenues before net income is determined. . . .

The lines between classes of costs or charges against revenues cannot be sharply drawn, but in broad outline (which is all that is necessary for consideration of concepts) they fall into two categories: product costs and period costs. The former are charged as the product is delivered (or the service is rendered), the latter as the period to which they are deemed applicable passes. This being so, it would be more accurate to describe income determination as a process of (1) matching product costs against revenues, and (2) allocating other costs to periods. 104


Gilman points out the difficulties of ascertaining income by the matching process in the following observations:

When the general accountant, as distinguished from the cost accountant, speaks of matching costs and income, he usually refers to their inclusion in the same accounting period, not to the direct relation of specific items of income to specific items of cost-outlay.

Assigning costs and expenses to the same accounting period in which so-called related income is recognized is often impossible due to two uncertainties, i.e., uncertainty as to time and uncertainty as to amount.

Expenditures made for purposes of research illustrate uncertainty as to time. Uncertainty as to amount may be illustrated by the guarantee of product not extending past the current fiscal period. 105

In general, it appears that the "matching principle" is being de-emphasized as the most useful standard for income accounting, either as an ideal which cannot be accomplished or as a process which is not most representative of what the accountant actually does or should do. What might be termed a more practical standard for income measurement may be suggested by the following statements prepared by the AAA Committee with regard to expense:

Expense is the cost of assets or portions thereof deducted from revenue in the measurement of income. These deductions arise through a current expenditure of cash, a total or partial expiration of asset cost, or the incurrence of a liability. Expense consists of operating cost—deductions that have a traceable association with the production of revenue, and losses—deductions that have no such association.

(1) Expense is given recognition in the period in which there is (a) a direct identification or association with the revenue of the period, as in the case of merchandise delivered to customers; (b) an indirect association with the revenue of the period, as in the case of office salaries or rent; or; (c) a measurable expiration of asset costs even though not associated with the production of revenue for the current period, as in the case of losses from floor or fire. The revenue deductions of a period include all costs not previously deducted from revenue and not applicable to future periods.  

It is clearly evident that the committee in the above statement indicates its support of the so-called "clean surplus" concept, which will be discussed in more detail in another part of this chapter.

The use of the terms "matching costs and income," "allocating costs to the periods which benefit from their expiration," and similar expressions are widely used by writers of accounting textbooks to indicate how periodic net income is determined. In their discussion of the process Finney and Miller place emphasis on the necessity for determining what costs have expired each period. They point out that there are two types of cost expirations: utilized cost and lost costs. Utilized costs represent expired costs which have contributed to revenue while lost costs have not. They also advocate as two useful standards of the income reporting the following:

If income is deferred because revenues are not regarded as realized, the related cost


should also be deferred. If future costs may be incurred which are applicable to revenues taken into income, provisions for such future costs should be made by charges into income.  

The following are examples of the comments appearing in some of the textbooks:

. . . The fundamental timing problem is essentially one of properly matching expenses against revenues for the period in question to produce an estimate which fairly presents the net income for the period under consideration without including any element of income or expense from any other period.  

The most important accounting 'principle,' in that it guides a very large proportion of the decisions made in accounting analysis and acts as a focal point for most accounting problems, is often expressed as 'matching costs and revenues.' By this we mean that we attempt to associate with a given revenue item, or with the revenue of a given accounting period, the corresponding amount of expenses, that is, costs incurred in connection with the earning of that revenue.

The problem is twofold: (1) the determination of the time or period in which revenue is earned, and (2) deducting the expenses which are associated either with the earning of revenue or with the accounting period in which the revenue is earned.

One of the cardinal objectives of accounting is to assess expense and loss against the related revenues for the purpose of determining the net income or net profit of a given fiscal period.

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MacKenzie lists several reasons why absolute matching of costs and revenues is not always done:

The expense of matching some costs with the revenue with which they should be matched is too great.

A satisfactory matching of costs with revenue may be obtained by recording some costs as expenses in a period preceding that in which the revenue for which they were incurred is obtained.

A satisfactory matching of costs with revenue may be obtained by recording some costs as expenses in a period subsequent to that in which the revenue for which they were incurred is obtained.

Costs so small that they make no material difference in the profit or loss of the accounting period are often recorded as expenses of that period, when actually part of the cost should properly be deferred to be deducted from revenues of future accounting periods. . .

Some costs such as part of the sales salaries might result in increased sales in a subsequent accounting period, yet a satisfactory matching of costs with revenue will usually be obtained each period by deducting the full amount of the sales salaries as an expense of that period.

Other costs such as those incurred in collecting accounts from customers will almost always be in part recorded in an accounting period subsequent to that in which the revenue was recorded. 112

Unusual Gains and Losses

One of the most complex problems in the measurement of periodic net income has to do with the disposition of expenses and losses of

accounting procedures, with the resultant effects upon reported profits or financial condition, were of concern to them alone. However, as we have observed, the characteristics of modern day business activities demand more uniform procedures and the establishment of a framework of accounting standards, which are consistent, fair, acceptable, and useful in the equitable determination of rights under our present economic and business society.

During the last decade, leaders in the promotion of sound accounting theory and practice have recognized the need for the development of a body of concepts and standards which would serve as the underlying philosophy for the application of accounting techniques. Much has been accomplished along these lines by the organized professional societies, their respective journals, and authors of textbooks and other accounting literature. Because it is felt that those persons who are to be responsible for the continued development of the profession are greatly influenced by the viewpoints expressed in the textbooks to which they are exposed at the various educational institutions throughout the country, the writer conceived it to be worthwhile to investigate the textbook treatment with regard to the fundamental theoretical aspects of accounting, in accordance with the three aims previously mentioned.

The Search for Accounting Principles

The issuance of the first of a series of "Accounting Research Bulletins" by the Committee on Accounting Procedure of the American Institute of Accountants in September 1939 marked an epochal step in the search for accounting principles, which has for several decades occupied the
an unusual nature. Gilman classifies such deductions into four classes:

- Operating recurring losses or gains.
- Operating non-recurring losses or gains.
- Non-operating recurring losses or gains.
- Non-operating non-recurring losses or gains.  

Decisions concerning the most appropriate manner for corrections of profits of past periods may be said to be similar in nature to those necessary in the handling of extra-ordinary gains and losses.

In accounting for extra-ordinary items, two phases of the problem are present: (1) Should these items be considered in ascertaining the net income for the period in question, and (2) if so, how should they be presented in the financial statements?

If charges and losses of the type under consideration are not deducted from the income of a particular period, it means that the adjustments will have to be made through the surplus account. In the final analysis, the most important phase of the issue breaks down into the simple question: "Are surplus adjustments proper?"

Opinion on whether surplus adjustments are proper appears to crystallize into three schools of thought: (1) those who believe in "clean surplus," holding the view that all expenses and losses incurred or recognized during each year should be reflected in the income account of that year; (2) those who believe that a sharp distinction should be made between surplus and income charges and credits depending on the nature of the items; and (3) a middle-of-the-road position based upon

various considerations in specific cases. The Committee on Accounting Procedure of the American Institute of Accountants summarized the controversy as follows:

The question of what constitutes the most practically useful concept of income for the year is one on which there is much difference of opinion. On one hand, net income is defined according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period except dividend distributions and capital transactions. The form of presentation which gives effect to this broad concept of net income has sometimes been designated the *all-inclusive* income statement. On the other hand, a different concept places the principal emphasis upon the relationship of items to the operations, and to the year, excluding from the determination of net income any material extra-ordinary items which are not so related or which, if included, would impair the significance of net income so that misleading inferences might be drawn therefrom. This latter concept would require the income statement to be designed on what might be called a 'current operating performance' basis, because its chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the period covered by the statement.114

A study of the conclusions reached by the committee and the proposals submitted in the above-mentioned bulletin seems to indicate that the members did not put forth a strong case for the adoption of either of the two positions pointed out above. Rather, it might be said that the opinion expressed can best be categorized as a "middle-of-the-road position."

In section 11 of Bulletin 32 the following statement is made:

The committee has previously indicated that, in its opinion, it is plainly desirable that over the years all profits and losses of a business be reflected in net income, but at the same time has recognized that, under appropriate circumstances, it is proper to exclude certain material charges and credits from the determination of net income of a single year, even though they clearly affect the cumulative total of income for a series of years. In harmony with this view, it is the opinion of the committee that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:

(a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;

(b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;

(c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes and similar calamities or catastrophes except where such losses are a recurrent hazard of the business.
(d) The write-off of a material amount of intangibles, such as the complete elimination of goodwill or a trademark;

(e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debt before maturity.\textsuperscript{115}

Perhaps the most authoritative support for the "clean surplus" concept comes from the 1948 statement by the American Accounting Association, in which is made the following statement:

\begin{itemize}
  \item (9) The income of an accounting period should be reported in a statement providing an exhibit of all revenue and expense (including losses) given accounting recognition during that period. This practice assures that the income statements for a period of years will disclose completely the entire income history of that period.
  \item (10) The income statement should be arranged to report consistently and in reasonable detail the particulars of revenue and the expense pertaining to the operations of the current period, measured as accurately as is possible at the time the statement is prepared and also any items of revenue or expense not associated with the operations of the current period. Such arrangement of data in a single statement discloses both the earning performance and the entire income history of the enterprise during a given period.\textsuperscript{116}
\end{itemize}

Another writer who advocates the "clean surplus" standard is Greer, who expresses the viewpoint that:

All gains and losses of whatever nature, except those arising from transactions in

\begin{itemize}
  \item \textsuperscript{115} Accounting Research Bulletin No. 32, "Income and Earned Surplus," December, 1947, American Institute of Accountants, pp. 262-264.
  \item \textsuperscript{116} Accounting Concepts and Standards Underlying Corporate Financial Statements, 1948, American Accounting Association, p. 7.
\end{itemize}
the company's own capital stock, should be reflected in the company's profit and loss account, either for the year in which they occur (if ascertainable) or for the year in which they are first recognized as having occurred. Adequate distinction should be made between current income and extraordinary non-recurring profit and loss items not related to current income.117

Paton and Littleton also have quite a bit to say in support of the "all-inclusive" income statement in the following quotations from their monograph:

A definite position is taken here to the effect that all determinants of income in the broadest sense—including unusual and irregular factors—should be reported in the income statement before the net results are passed to the stock-equity section of the balance sheet.118

Non-operating, non-recurring losses should exhaust current net income before falling upon earned surplus, exhaust earned surplus before being applied to paid-in surplus, and being considered as impairing stated capital; and non-operating, non-recurring gains should augment net income rather than directly affect earned surplus, paid-in surplus, or surplus reserves.119

The doctrine of direct surplus adjustments, indeed, opens the door to a program which obscures the effect of special losses and gains, with resulting misunderstanding on the part of stockholders and other interested. If shuffling and tinkering in the reporting of income are to be avoided the practice of making corrections outside the income statement must be rejected.120

119Ibid., p. 97.
120Ibid., p. 110.
Despite the strong case which has been presented to eliminate surplus adjustments several leaders in accounting thought have taken the opposing view, of which the following statements are examples:

... Cases occur in which the inclusion of charges or credits growing out of the past, in the current income statement, would by reason of their relative magnitude be likely to result in a distorted impression as to the results of operations for the year. In such cases, charges or credits to surplus are and probably should be regarded as permissible.  

When, in computing profits for a past accounting period, an error has been made the correction of which does not involve an amount so large as materially to distort the income statement for the current period, the error may properly be corrected through the income statement rather than through surplus. Since by assumptions such corrections in the income statement are small in amount, they may properly be combined with the items to which the corrections apply.

If, however, the amount involved is sufficiently large to distort materially the income statement for the current period, the correction should not go through income, but through surplus.  

Recurring surplus adjustments should be viewed with concern and should be resisted. On the other hand, charges and credits applicable to prior years which would tend to distort current year's net results should be carried to earned surplus.

If the Gordian Knot were cut by eliminating direct entries to surplus entirely or reducing


them to a few relatively unimportant instances
a rigidity would be introduced into the deter-
mination of income which would be unfortunate
in its broad effects.124

It is interesting to note that authors of textbooks likewise
line up into three schools of thought with respect to the correct
handling of unusual profit and loss items. In upholding the clean
surplus concept, Bolon, Fleig, and McCoy state:

Some errors may be applicable to revenue or
expense of previous accounting periods. The
net income of those periods has been trans-
ferred by the closing entries to the equity
of owner account or to the retained income
in the case of a corporation. The correction
might be made in those accounts, but if that
is done, the amount of the revenue or expense
involved will never appear on the statements
of operations. As a result, those statements
for a series of years will not present either
the complete or correct results of all opera-
tions.

A better treatment is to record the corrections
in an account called 'corrections of income of
prior periods,' which is shown in the non-
merchandising section of the statement of
operations for the current year.

This method, which is called the 'all-inclu-
sive statement of operations,' makes it pos-
sible to present the complete results of
operations for a period of years on the state-
ment of operations for those years.125

In his discussion of the issue, Johnson expresses the following
opinion:

124W. A. Hosmer, "The Effect of Direct Charges to Surplus on the
1938, p. 46.

125Dallas Bolon, Wilfred J. J. Fleig, and James R. McCoy, Introduction
to Accounting, Vol. II, Columbus, Ohio: 1950, p. 126.
Even if the practice of debiting 'non-regular' items directly to Earned Surplus were deserving of sanction, the worthwhileness of the practice would be doubtful. Expediency and common sense would dictate the propriety of placing these items in the current Profit and Loss account instead of in Earned Surplus. Especially would this be true if the effect upon the amount of periodic net income were insignificant. In other cases the inclusion of extraneous expense items in the current Profit and Loss account of a period would be well justified upon the grounds that irregular or extraordinary expenses recur regularly year after year. In other words, these irregular costs, when considered as a group, are just as regular an expense of periodic operations as any of the more commonly accepted expense groups. Similar comments apply to irregular or extraordinary items of income.

According to Paton:

The general position taken here is that all specific items of loss and gain should be associated with current incomes unless circumstances make such treatment clearly unreasonable and hence justify a direct charge or credit to surplus. Further, the practice of clearly disclosing in the periodic income statement all losses and gains directly assigned to surplus is strongly recommended.

Giving support to the use of surplus charges and credits for unusual items and corrections of errors for past periods, MacFarland and Ayars state:

Occasionally during a period or at the time periodic adjustments are being made, errors of prior periods are discovered. These errors should be handled in such a manner that the operating results of the current period are


not disturbed by them. They represent debits and credits to Surplus rather than Profit and Loss.

... The practice of closing unusual profit and loss items to Surplus and the usual operating nominal account balances to Profit and Loss causes the latter account to reflect the results of current operations only. The figures of Profit and Loss may be compared, therefore, period by period to determine the trend of operating results. 128

Several of the textbook writers decided, for such a controversial issue, to present discussions of both views and also the positions taken by the American Accounting Association and the American Institute of Accountants. Among them are Mackenzie, 129 Mauriello, 130 Tunick and Saxe, 131 and White. 132

An example of a compromise position is the statement by Mason, Stenberg, and Niven:

It is not uncommon to discover errors affecting the operating results in an accounting period subsequent to that in which the error was made. If the amount of the correction is small, the entry may, as a matter of convenience be handled through the current operating accounts. If, however, the amount is so large that it would seriously distort the current net income, the adjustment should be made through the proprietorship account to which the net income of such prior period has been closed. 133

Chapter VII
SPECIAL PROBLEMS OF INCOME DETERMINATION

Depreciation

In previous chapters, especially Chapter 7 dealing with changing price levels and the determination of income, the problems of depreciation accounting have been mentioned. Perhaps in no other area of accounting has there been so much controversy.

One factor leading to considerable misunderstanding with regard to depreciation is a failure to understand the accountant’s concept of the nature of a depreciation allowance. This is due in part to the early emphasis upon value in accounting. This is manifested by a number of definitions which describe a depreciation charge as an "estimate of the loss in value due to wear, tear, the action of the elements, obsolescence, etc."

Gilman states:

There is little reason to doubt that depreciation was originally calculated on the basis of appraisals... The appraisal, it may be conjectured, was originally on a market price basis in order to obtain a figure roughly equivalent to what would have been realized at the date of the appraisal had the asset actually been sold. This appraisal viewpoint persisted for many years and in fact has not yet entirely disappeared...

After general adoption of the accounting period convention, such appraisals were probably made at the end of each accounting period. It must,
time and thought of leaders in accounting theory and practice.

In recent years the accounting profession has been subjected to considerable criticism as one which had no principles, rules, or generally accepted standards, despite the widely prevalent use in audit certificates of the phrase, "in accordance with generally accepted principles of accounting." On the other hand, while probably willing to admit that wide variance in accounting methods and practices did exist, the national organizations of public and private accountants and teachers of accounting, representing the entire profession, stood ready to claim that there was a central core of generally accepted procedures to which the majority of the profession subscribed. What was lacking was the weight of some central authority in the form of published statements, pronouncements, etc., to which reference could be made much like the decisions of the courts of law. The American Institute of Accountants, through the significant contributions of the Committee on Accounting Procedures, has sought to fulfill this need.

The beginning of the publication of the research bulletins was not the first time that the accounting profession had addressed itself to the task of trying to standardize practices and improve the effectiveness of accounting. The 1922 Yearbook of the American Institute of Accountants reveals that there existed a special committee which mainly served as a clearing house for technical problems which arose in the course of the practice of the profession, answering questions which were submitted to it with regard to specific situations. However, the work of this committee was very limited in scope and did not carry much authoritative weight.
however, soon have been obvious that such peri-
doic appraisals gave erratic results depending,
of course, upon who made them, how they were
made and the general state of business at the
time they were made. Conceivably a fixed asset
could show a value at the end of one period
larger than the value established at the end
of the previous period in spite of intervening
deterioration.\textsuperscript{134}

Paton and Littleton also consider appraisals to be an unsatis-
factory method of measuring depreciation. They write:

Any attempt to measure the annual depreciation
charge by periodic examination or appraisal is
likely to yield very unsatisfactory results.
Depreciation is not merely a matter of physical
condition; opinions based purely on inspection
are likely to be inconsistent from period to
period. What is needed is a systematic, coher-
ent policy based on the probable history of the
plant elements under consideration.\textsuperscript{135}

Another misapplication of depreciation accounting which probably
flourished at one period but has generally been eliminated is the idea
that an allowance for depreciation is an arbitrary charge that can be
made or left out, increased or decreased at the will of the business
owner. Gilman termed this concept a delusion that "depreciation is a
function of profits and that more depreciation should be taken during
a profitable year than during an unprofitable year."\textsuperscript{136}

In expressing themselves against such a viewpoint, Paton and
Littleton say:

\textsuperscript{134}Stephen Gilman, \textit{Accounting Concepts of Profit}, New York: The Ronald

\textsuperscript{135}W. A. Paton and A. C. Littleton, \textit{An Introduction to Corporate Ac-
counting Standards}, 1940, American Accounting Association, p. 85.

\textsuperscript{136}Stephen Gilman, \textit{Accounting Concepts of Profit}, New York: The Ronald
The doctrine that the amount of periodic depre-
ciation should be related to income is not
acceptable, especially if it is employed to
make the "fat years pay for the lean." Depre-
ciation must not be deferred merely because
there has been a falling off in the volume of
business, on the ground that "revenue cannot
stand the charge." The typical enterprise is
not a guaranteed affair with its plant assets
impregnable because of certainty of recovery in
fair weather assumed to be lying ahead. Most
processes of decay are not arrested by absence
of activity, and technical progress is not at
a standstill during a period of depression.\textsuperscript{137}

Another misconception with respect to the nature or the purpose
of the depreciation allowance is that such charges create a fund
which will be available for the replacement of assets at the time of
their retirement. This concept, which has been discussed to some
extent in a previous chapter, is probably due in part to the use of
the term "Reserve for Depreciation," as the name of the account in
which is recorded accumulated depreciation charges. The term "reserve"
conveys the impression that funds are set aside for a specific purpose,
which does not describe the techniques of depreciation accounting at
all. A number of accountants have proposed that another term, such as
"Allowance for Depreciation," or something similar be adopted instead
of continued use of "reserve."

In their discussion of this particular issue Sanders, Hatfield,
and Moore make the following observations:

\textsuperscript{137}W. A. Paton and A. C. Littleton, \textit{An Introduction to Corporate Ac-
counting Standards}, 1940, American Accounting Association, pp. 85-86.
the years. By the end of the year, however, if all expenses (including depreciation) have been recovered out of gross income, new resources have been received to replace the value of property consumed in operations. The original source of these new assets is gross income, yet on account of the earmarking of a portion of the gross income as covering depreciation it is a common thing to speak of the reserve for depreciation as the source of the new assets. But the reserve for depreciation by no means implies a segregated and specific fund is required, it is necessary to appropriate cash or other suitable assets and to show it in some form as a separate item on the assets side.138

In support of this viewpoint Gilman states:

There is, of course, no accounting relation between the amortization of an existing asset and its ultimate replacement. Such replacement, if, as, and when it occurs, is a new separate, and distinct undertaking.

The availability of money for replacement may offer serious financial problems. The problem of financing replacements may be sufficiently difficult to tax the resourcefulness and foresight of business men but it is in no sense whatever an accounting problem. The originally acquired asset was a deferred charge and its cost is recovered by the depreciation program. The replacement, whether it be an identical item or not, is a fresh transaction resulting in the creation of a new deferred charge the cost of which in turn must, from the accounting viewpoint, be recovered over the years which follow its acquisition.139

Likewise the committee on terminology of the American Institute of accounts comments as follows:


It may be desirable to point out that depreciation is only indirectly related to replacement. It contemplates the amortization of the cost of existing property—not anticipation of the cost of replacing it as a replacement reserve might do. Whatever may be the merits of these two approaches to the determination of the proper charges to operations in respect of property which has a limited life and must be replaced if operations are to continue, it must be recognized that they differ. In one case changes in price levels are reflected in the new capital-asset account; in the other, they are reflected in operating charges.\footnote{Accounting Research Bulletin, No. 16, "Report of Committee on Terminology," October, 1942, American Institute of Accountants, p. 142.}

The preceding discussion has been slanted toward correcting misunderstanding of the nature of the accountant's concept of depreciation. Emphasis was placed on what depreciation accounting is not trying to do. It is in order then, that consideration be given to what the accountant is attempting to show by his depreciation charge.

Briefly, it may be said, as reflected in present day theory and practice, accountants conceive of depreciation accounting as a systematic process of allocating the cost of fixed assets over the period of their useful life. This concept considers the amounts invested in fixed assets as deferred charges to operations. Thus, they are treated in the same manner as some other assets which might not last as long. For instance, in the same way that an insurance premium for three years of protection is prorated over the period involved on an equitable basis, the cost of a fixed asset is distributed over a longer period.

Perhaps the best description of depreciation accounting is embodied in a suggested definition by the committee on terminology of the American
Institute of Accountants:

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year it is not intended to be a measurement of the effect of all such occurrences.

In general, the discussions of depreciation appearing in the various textbooks studied were in close agreement with the views adopted by the Institute. In several cases, the above definition was repeated in the textbooks. Typical statements are the following:

Depreciation should not be confused with 'fluctuation.' Fluctuation refers to changes in economic or market values, and hence includes appreciation. Depreciation, on the other hand, refers to the allocation of cost over the service life of an asset in recognition of physical deterioration and functional obsolescence. Fluctuations in economic values of fixed assets are normally disregarded on the books of account for the reason that fixed assets are acquired for use in operations, not for sale.

Placing the accounting emphasis on the absorption of cost rather than on physical deterioration gives recognition to the fact that depreciation charges are not intended to parallel physical decline. Depreciation charges are intended to spread the cost of the asset over the years of its usefulness in an equitable manner; this result would not be accomplished.


if the accumulated depreciation charges followed the curve of physical depreciation.\textsuperscript{143}

The cost of a depreciating asset, then, is the price paid for a series of future services. The amount paid for the asset is a type of deferred charge or prepaid expense, similar in many respects to prepaid rent or insurance—a payment in advance for services to be received. As the asset is used in each accounting period, an appropriate portion of the investment in the asset is treated as the cost of the service received and is charged to the operations of that period.

Note especially that depreciation has nothing directly to do with replacement of an asset when it is worn out and retired from service. Whether or not an asset is to be replaced has no influence on the calculation of its depreciation.\textsuperscript{144}

Once the nature of depreciation accounting is understood, accounting problems in connection with depreciation may be broken down into three phases: (1) methods for determination of the charge which is to be made each accounting period, (2) revisions of the charge which may become necessary during the life of the asset, and (3) techniques for recording the disposal of the asset or retirement from service. No attempt will be made here to investigate the merits of various methods of calculating the depreciation charge, or the mechanics of handling the two other phases of the problem. These may be considered to be procedures or methods, rather than principles, concepts, or standards.


Inventories

It has long been recognized that for businesses which operate with a stock of goods that it is necessary to give adequate attention to the inventory in order to ascertain the profit or loss for the year. In the days when the emphasis in accounting was on valuation, the accounting treatment of inventories generally involved a periodic counting of the goods on hand, expressing them in terms of dollar amounts, which sum when deducted from the total goods available for sale would yield a residual amount considered to be the cost of goods sold.

It was in the valuation era that the well known rule of inventory pricing, cost-or-market, became widely used—a rule which persists even today. The cost-or-market rule of inventory valuation involves the pricing of all articles in stock at both cost and replacement price. Where the replacement price is below cost, the accountant substitutes that price for the original cost price in establishing a final inventory figure at the end of the fiscal period. In its use, cost-or-market represents an application of the doctrine of conservatism, discussed in a previous chapter, and embodied in the statement "provide for all losses but do not anticipate profits."

The shift in emphasis from the valuation, or balance sheet, approach to accounting to the profit and loss statement has resulted in the development of different standards of accounting for inventories.
In Accounting Research Bulletin No. 29, the Committee on Accounting Procedure set forth standards of acceptable practice in accounting for inventories. The following quotations provide a good summary of present-day thought in this area:

In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is in effect a residual amount remaining after the matching of absorbed costs with concurrent revenues. This residual is appropriately carried to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward.\textsuperscript{145}

The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.\textsuperscript{146}

Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as "first-in first out," "average," and "last-in first-out"); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.\textsuperscript{147}

As a result of much condemnation of the "lower of cost or market" rule, the Research Committee of the AIA introduced the following modification or limitation upon its applicability:


\textsuperscript{146}Ibid.

\textsuperscript{147}Ibid., p. 237.
A departure from the cost basis of pricing the inventory is required when the usefulness of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as "market."\(^{148}\)

As used in the phrase "lower of cost or market," the term "market" means current replacement cost (by purchase or by reproduction, as the case may be) except that:

1. Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and

2. Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.\(^{149}\)

Depending on the character and composition of the inventory, the rule of "cost or market, whichever is lower," may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category). The method should be that which most clearly reflects periodic income.\(^{150}\)

Paton and Littleton object to the time-honored "cost or market" rule in the following forceful manner:

It cannot be gainsaid that a sharp change in cost prices, in either direction, may have


\(^{149}\)Ibid., p. 239.

\(^{150}\)Ibid., p. 240.
a bearing——though the inventory——on the working-capital position of the enterprise. Nevertheless, the complete substitution of estimated replacement costs of inventory for costs actually incurred in the process of matching revenue and cost is seriously objectionable. Aside from the difficulty of making the necessary estimates (a particularly troublesome task for complex manufacturing inventories), the use of hypothetical costs rather than recorded costs in computing cost of sales results in a distortion of such figure and of the operating net. If the substitution takes the form of a write-down, under the application of "cost or market, whichever is lower," the amount charged to revenue as the "cost of goods sold" is definitely inflated by the estimated price shrinkable attaching to goods not yet sold. The effect is a clear violation of the standard which requires that revenue be measured in terms of sales, and that revenue be charged with the costs of materials and services applicable thereto. 151

A highly controversial issue that has developed in the area of inventory accounting is the adoption of the lifo method, in which the most recent costs of inventory items are measured against revenue in the determination of periodic income. This procedure, like proposals to take depreciation on replacement cost, grew out of an effort to offset the effects of an unstable monetary unit, and to remove some of the "inventory profits," from the net income figure. The continued high level of income taxes no doubt has caused a number of companies to adopt this method. It is a legally permissible means of reporting a lower taxable income.