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Tentative set of broad accounting principles for business enterprises; Accounting research study no. 03

Robert Thomas, 1922-2007 Sprouse

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3

AN ACCOUNTING RESEARCH STUDY

A TENTATIVE SET
OF BROAD ACCOUNTING
PRINCIPLES FOR
BUSINESS ENTERPRISES

By Robert T. Sprouse, Ph.D. and Maurice Moonitz, Ph.D., CPA

This research study is published for discussion purposes. It does not represent the official position of the American Institute of Certified Public Accountants.

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STATEMENT OF POLICY

The Director of Accounting Research of the American Institute of Certified Public Accountants publishes this accounting research study under his authority to circulate the results of the research activities of his staff.

Accounting research studies are designed to provide professional accountants and others interested in the development of accounting with a discussion and documentation of accounting problems. The studies are intended to be informative, but tentative only. They furnish a vehicle for the exposure of matters for consideration and experimentation prior to the issuance of pronouncements by the Accounting Principles Board.

The responsibility for this study is that of the Director of Accounting Research and those who have been associated with him in the project. The conclusions and recommendations have not been approved, disapproved, or otherwise acted upon by the Accounting Principles Board, the only agency of the American Institute of Certified Public Accountants having authority to make or approve public pronouncements on accounting principles. The study does not necessarily reflect the views of the Board, nor has it been acted upon by the membership or by the governing body of the Institute.

Individuals and groups are invited to express their views in writing on the conclusions and recommendations contained in this study. These views will be considered by the Accounting Principles Board in forming its own conclusions on the subject.

**A TENTATIVE SET
OF BROAD ACCOUNTING
PRINCIPLES FOR
BUSINESS ENTERPRISES**

**ACCOUNTING
RESEARCH
STUDY NO. 3**

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OF BROAD ACCOUNTING
PRINCIPLES FOR
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By Robert T. Sprouse, Ph.D.

University of California

and

Maurice Moonitz, Ph.D., CPA

American Institute of CPAs

**AMERICAN
INSTITUTE
OF CPAs**

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Statement by the Accounting Principles Board

The Accounting Principles Board has received *Accounting Research Study No. 3*, "A Tentative Set of Broad Accounting Principles for Business Enterprises," by Robert T. Sprouse and Maurice Moonitz. The Board previously had received *Accounting Research Study No. 1*, "The Basic Postulates of Accounting," by Maurice Moonitz. Study No. 1 was published in September 1961 and Study No. 3 is scheduled for publication toward the end of April 1962.

In the opinion of the Director of Accounting Research, these two studies comply with the instructions to the Accounting Research Division to make a study of the basic postulates and broad principles of accounting. Prior to its publication, Study No. 3 has been read and commented upon by a limited number of people in the field of accounting. Their reactions range from endorsement of the ideas set forth in the study of "Broad Principles" to misgivings that compliance with the recommendations set forth by the authors would lead to misleading financial statements. The Board is therefore treating these two studies (the one on "Postulates" and the other on "Principles") as conscientious attempts by the accounting research staff to resolve major accounting issues which, however, contain inferences and recommendations in part of a speculative and tentative nature.

The Board feels that there is ample room for improvement in present generally accepted accounting principles and a need to narrow or eliminate areas of difference which now exist. It hopes the studies will stimulate constructive comment and discussion in the areas of the basic postulates and the broad principles of accounting. Accounting principles and practices should be adapted to meet changing times and conditions, and, therefore, there should be experimentation with new principles and new forms of reporting to meet these conditions. The Board believes, however, that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time.

After a period of exposure and consideration, some of the specific recommendations in these studies may prove acceptable to the Board while others may not. The Board therefore will await the results of this exposure and consideration before taking further action on these studies.

April 13, 1962

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Preface

This study is a companion to *Accounting Research Study No. 1*, "The Basic Postulates of Accounting," by Maurice Moonitz, and completes the initial assignment of the Accounting Research Division of the American Institute of Certified Public Accountants to study the basic postulates and the broad principles of accounting. The first draft of this study was prepared by Robert Sprouse. It was then entirely reworked in the light of the findings of the postulates study in order to integrate the two projects.

As in the case of the postulates study, the members of two advisory committees rendered valuable assistance at all stages of the work. The committee on broad accounting principles was under the chairmanship of John H. Zebley, Jr., with Andrew Barr, Carman G. Blough, Paul Grady, George S. Hills, and Herbert E. Miller as the other members. The committee on basic accounting postulates consisted of Arthur M. Cannon, as chairman, Martin R. Gainsbrugh, Oscar S. Gellein, C. A. Moyer, Leonard Spacek, and William W. Werntz. Members of these advisory committees reviewed the plan for research in its early stages, acted as a sounding board for conclusions reached by the staff, and advised the Director of Accounting Research as to the suitability of the study for publication. The responsibility for the study, however, is that of the Director of Accounting Research, and not that of the members of the advisory committees. The association of the members of the advisory committees with this project does not constitute an endorsement by them of the findings or the recommendations set forth. Under the rules of procedure of the Research Division, however, each member of an advisory committee has the right to have his comments included in the published study, if he so desires. In this regard we call attention to the views of Andrew Barr, Carman G. Blough, Arthur M. Cannon, Oscar S. Gellein, Paul Grady, Herbert E. Miller, Leonard Spacek, William W. Werntz, and John H. Zebley, Jr. which follow immediately after the concluding chapter of our study.

Throughout this project we have tried to hold to three guidelines,

(1) to make sure that the principles we set forth were compatible with the "basic postulates" of *Accounting Research Study No. 1*, (2) to carry the analysis, discussion, and illustrations far enough to make clear the implications of the principles but not so far as to convert the study into a handbook or manual of procedure, and (3) to formulate recommendations that can actually be reduced to practice in the light of the present level of knowledge about economic and business affairs.

New York, N. Y., April 1962

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Introduction

Accounting is concerned with the administration of economic resources. Since most productive resources are owned or controlled by business enterprises, accounting has received its greatest challenge as well as opportunity from their problems. Accounting supplies much of the comprehensive and dependable information that management needs to control and administer the resources in its charge efficiently and productively. It also supplies the data that management needs to fulfill its responsibility to report to owners, creditors, government, and others with *bona fide* interests. In turn, these owners, creditors, government, and others rely on accounting reports to assist them in determining and evaluating the performance of management and the business system.

The principles of financial accounting that are developed in this study are designed to meet the needs of all interested groups. Accordingly, they are necessarily set forth in broad terms of objectives and major criteria. The complexities of modern business make it necessary to formulate more specific rules, beyond the principles themselves. In a dynamic world, detailed rules need to be altered as conditions or modes of thought change. But changes in the detailed rules do not necessarily affect the broad principles and basic postulates, all of which are comprehended in the term, generally accepted accounting principles.

Many forces have been at work over the past half century or more in shaping the specific content of accounting and of published financial statements. Two are of special importance:

(a) The need to determine if the "capital" of the accounting entity has increased, decreased, or remained the same. This need is widespread, almost universal.

In the context of the business enterprise, "capital" has usually been defined as identical with the ownership interests, but other uses are permissible. For example, "capital" is also frequently defined to cover the interests of all contributors of "permanent" capital, whether the contributors hold shares of stock or evidences of indebtedness.

In the context of the entity without ownership interests (e.g., schools, churches, clubs, charitable organizations, governmental agencies, and other "nonprofit" organizations), "capital" is identified with the resources entrusted to the entity or dedicated to the furtherance of its objectives, and described by a variety of terms, such as fund balances, fund equity, principal or corpus (of an estate or trust).

(b) The need to determine the amount of profit subject to income tax. This need is restricted by definition to those entities subject to a tax measured by profit.

The question as to whether capital has been maintained or not is of some importance in all forms of economic organization, is especially important in the case of business enterprises, and, historically, has been most important in the case of the business corporation. As the Study Group has said, "Financial accounting becomes especially necessary when forms of business organization are created in which management and beneficial ownership may be disassociated; it has grown in importance with the development of the private limited liability company."¹ The consequent need to determine if a proposed distribution would impair capital or not has made the amount of "profits available for dividends" particularly significant.²

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On balance the impact of income taxation on accounting practice and its theory has been beneficial even though some tax rules are not in accord with sound accounting. For one thing the taxing authorities insist on books and records to support the tax return; for another thing

¹ Study Group on Business Income, *Changing Concepts of Business Income* (New York, 1952), pp. 21-22.

² BIBLIOGRAPHICAL NOTE: These developments can be traced in numerous sources. A convenient source on "profits available for dividends" is Henry Rand Hatfield's *Accounting: Its Principles and Its Problems* (New York, 1927). The references at the end of each of his chapters cover the developments in England and the U. S., and, to a lesser extent, in Germany and France. Later (1941-42) Hatfield delivered the Dickinson Lectures, at Harvard, published by the Harvard University Press in 1943 under the title "Surplus and Dividends," in which the same developments are reviewed and brought up to date.

Starting in 1947, the Study Group on Business Income, financed jointly by the American Institute of Certified Public Accountants and The Rockefeller Foundation, conducted an extensive investigation, culminating in the publication of its report under the title, *Changing Concepts of Business Income* (New York, 1952). As part of its deliberations, the Study Group published a series of special studies, the titles of which are listed in the "Bibliography" of the Study Group's report. These studies, together with

the amount and timing of the tax depend in large measure on the results of the accounting process. A climate is therefore created in which the resolution of accounting issues has important practical consequences and discussion of accounting issues on all levels is fostered.

The broad principles of accounting should apply just as much to unincorporated as to incorporated enterprises. The combined effect of the dividend and tax questions, however, has focused attention on the financial statements of publicly held corporations. As one result, "generally accepted accounting principles" have been formulated in recent years largely to meet the problems of the corporation with widespread share ownership. This development is understandable and natural, perhaps inevitable. We shall endeavor, however, to view the problems in a broader perspective, to develop principles that are more widely applicable.

We also wish to point out that the principles developed below are not intended to restrain or restrict the compilation and presentation of other kinds of accounting or statistical data for internal purposes or as supplementary information included in a published report as part of the disclosure of significant information and as an aid to interpretation of the financial data. In administering the enterprise, business management always has needed and always will need data outside the formal financial statements. We see no conflict, for example, between (1) the compilation of data as to actual shipments of the current year, unfilled orders at various times during the current year, and estimated shipments of the next year, as a basis for planning operations, and (2) the restriction of "revenue," in a formal statement of the results of operations of the same company, to shipments actually made, without reference to unfilled orders or estimated shipments. The principles we are concerned with are those which are relevant to the preparation of formal reports on some aspect of financial position or of the results of operations—reports which are made available to third parties as representations by the management of the enterprise.

Definition of financial statements. The committee on auditing pro-

the report itself, constitute a rich source of information and analysis on the impact of business organization, tax laws, changing prices, and other forces, on financial accounting.

A more recent source, somewhat specialized, is *The Law of Accounting and Financial Statements*, by George S. Hills of the New York Bar, published by Little, Brown & Company, Boston, in 1957.

cedure has defined “financial statements” as those which purport to show financial position and results of operations.³ For a given business corporation they usually consist of a balance sheet, an income statement, an analysis of retained earnings, and an analysis of other changes in stockholders’ equity. By extension of this definition, we include supporting schedules (e.g., giving details of inventories or of plant and equipment), elaborations of special aspects of business activity (e.g., a statement or analysis of “cash flow”), rearrangements of underlying data (e.g., a statement of source and application of funds), and supplementary statements (e.g., a statement incorporating the effects of price-level changes). The limits of the definition are implied in Postulate B-1 which states that “the results of the accounting process are expressed in a set of fundamentally related financial statements *which articulate with each other and rest upon the same underlying data*”⁴ (emphasis added).

4 In the interest of brevity, the discussion in this monograph centers upon the balance sheet and the earnings statement as the two most strategic financial statements. This concentration should not, however, be construed as a denial of either the function or the importance of any other financial statement which falls within the scope of the definition given above.

Balance Sheet and Income Statement

One of the more apparent results of the influence of the forces referred to above was the shift from emphasis on the statement of financial position (balance sheet) to the statement of the results of operations (earnings statement). This development is expressed in the “Introduction” to *Accounting Research Bulletin No. 43*.⁵

. . . the problems in the field of accounting have increasingly come to be considered from the standpoint of the buyer or seller of an interest in an enterprise, with consequent increased recognition of the income statement and a tendency to restrict narrowly charges and credits to surplus. The fairest possible presentation of periodic net income, with neither material overstatement nor understatement, is important, since the results of operations

³ *Statement on Auditing Procedure No. 28*, “Special Reports.” 1957. Paragraph 5.

⁴ The complete set of “basic postulates” is given on pages 6 and 7.

⁵ *Restatement and Revision of Accounting Research Bulletins*, American Institute of Certified Public Accountants (New York, 1953), p. 7, par 3.

are significant not only to prospective buyers of an interest in the enterprise but also to prospective sellers. With the increasing importance of the income statement there has been a tendency to regard the balance sheet as the connecting link between successive income statements; however, this concept should not obscure the fact that the balance sheet has significant uses of its own.

The results of the shift to the earnings statement have been mixed. Some improvements have occurred, for example, with regard to the classification of revenue, expense, and profit. In addition the extent of disclosure of operating results and trends has vastly improved. At the same time, however, a marked retrogression has occurred with respect to certain elements of the balance sheet, notably inventories and plant and equipment, and with respect to the related diversity of acceptable methods of measuring expenses in the income statement.

Since the late 1930's, for example, the last-in-first-out (Lifo) method of inventory pricing has been recognized as equally acceptable with the first-in-first-out (Fifo) method. This has created a situation in which identical business transactions result in substantially different figures for cost of goods sold and for inventories, depending upon the use of Lifo or of Fifo. Similarly, the existence of two acceptable tax methods for treating intangible drilling costs in the oil industry is paralleled by two acceptable methods for treating them in the financial statements. The result again is to find identical business events reported in markedly dissimilar ways.

Both experience and abstract analysis tell us in unmistakable terms that any attempt in accounting to emphasize either the balance sheet or the income statement to the virtual exclusion of the other is bound to give disappointing results. Neither lives in isolation from the other. Both must be considered in an integrated attack on the problem of financial reporting.

The time seems ripe for a thorough review of the problems of accounting. Experience is available to indicate the strengths and weaknesses of the balance-sheet and income-statement approaches. The way to avoid the undesirable features of either one can be seen. The past has also produced a wealth of studies and pronouncements by accounting organizations (e.g., American Institute of Certified Public Accountants, American Accounting Association, National Association of Accountants, Controllers Institute, English and Canadian Institutes) and by individual investigators (e.g., Dickinson, Hatfield, May, Paton, Canning, Littleton) to give us the essential analytical frame-

work. The Division of Accounting Research of the American Institute of Certified Public Accountants published its study of the postulates of accounting on October 1, 1961.⁶ That study serves as a point of departure for a more specific attack on the problems of accounting.

The Foundation for the Principles

The basic postulates themselves are listed below for ease of reference:

Postulate A-1. Quantification. Quantitative data are helpful in making rational economic decisions; i.e., in making choices among alternatives so that actions are correctly related to consequences.

Postulate A-2. Exchange. Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers.

Postulate A-3. Entities (including identification of the entity). Economic activity is carried on through specific units or entities. Any report on the activity must identify clearly the particular unit or entity involved.

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Postulate A-4. Time period (including specification of the time period). Economic activity is carried on during specifiable periods of time. Any report on that activity must identify clearly the period of time involved.

Postulate A-5. Unit of measure (including identification of the monetary unit). Money is the common denominator in terms of which the exchangeability of goods and services, including labor, natural resources, and capital, are measured. Any report must clearly indicate which money (e.g., dollars, francs, pounds) is being used.

Postulate B-1. Financial statements. (Related to A-1.) The results of the accounting process are expressed in a set of fundamentally related financial statements which articulate with each other and rest upon the same underlying data.

Postulate B-2. Market prices. (Related to A-2.) Accounting data are based on prices generated by past, present, or future exchanges which have actually taken place or are expected to.

Postulate B-3. Entities. (Related to A-3.) The results of the accounting process are expressed in terms of specific units or entities.

⁶ Maurice Moonitz, "The Basic Postulates of Accounting." *Accounting Research Study No. 1*. American Institute of Certified Public Accountants. 1961.

Postulate B-4. Tentativeness. (Related to A-4.) The results of operations for relatively short periods of time are tentative whenever allocations between past, present, and future periods are required.

Postulate C-1. Continuity (including the correlative concept of limited life). In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

Postulate C-2. Objectivity. Changes in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like, should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms.

Postulate C-3. Consistency. The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

Postulate C-4. Stable unit. Accounting reports should be based on a stable measuring unit.

Postulate C-5. Disclosure. Accounting reports should disclose that which is necessary to make them not misleading.

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The first five postulates (A-1 to A-5, inc.) led to the following statement of the functions of accounting:⁷

- (1) to measure the resources held by specific entities
- (2) to reflect the claims against and the interests in those entities
- (3) to measure the changes in those resources, claims, and interests
- (4) to assign the changes to specifiable periods of time
- (5) to express the foregoing in terms of money as a common denominator

The kinds of evidence, analysis, and reasoning that led to the preceding postulates and functions are summarized as follows in the postulates study (p. 51):

Economic activity is carried on by human beings interacting with their environment. This type of interaction of human effort (labor) and natural resources takes place through the medium of entities which are used as organizing units for the purpose of producing goods and services. In this process the existing resources must be allocated by some means among the available

⁷ *op. cit.* p. 23.

alternatives. To make these allocations properly, predictions as to the outcome of the available alternatives are essential. Results of the past and estimates of the future are used to form these predictions. These results, estimates and predictions are couched in part in quantitative terms so that comparisons and evaluations can be facilitated. Accounting is one form of quantitative expression that is widely used.

In their economic aspects, all organized societies of which we have knowledge are concerned with the production and distribution of wealth; all use entities of one kind or another to accomplish the result. Accordingly, accounting is and always will be closely identified with *wealth* and with *entities*.

Specifically, we observe that every single example of accounting in actual or potential use deals with some aspect of wealth—its creation, its form, its consumption, its safeguarding, its magnitude, its augmentation, or its diminution. And every aspect of this wealth is assignable or attributable to one or more entities.

Definitions

8 For convenience, the definitions of the principal terms used in this study are listed immediately below, as well as in the Summary (Chapter 7). Each definition is developed or explained in its appropriate place in the discussion in Chapters 2-6, inclusive.

Financial statements are those which purport to show financial position and results of operations, including supporting schedules, elaborations on special aspects of business activity, rearrangements of underlying data, and supplementary statements.

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

Cost is a forgoing, a sacrifice made to secure benefits, and is measured by an exchange price.

Depreciation accounting is the process of allocating the cost or other basis of measurement of the services rendered by items of plant and equipment to the products or periods that used those services. *Depreciation for any given period* is the cost or other basis of the services used up in that period.

Liabilities are obligations to convey assets or perform services, obligations resulting from past or current transactions and requiring settlement in the future.

Owners' equity is represented by the amount of the residual interest in the assets of an enterprise.

Invested capital is that portion of stockholders' equity which arose from the commitment of assets to the corporation or from the conversion of retained earnings and which will not be withdrawn or reduced except as permitted by law. *Retained earnings (earned surplus)* is the portion which arose from operations and has not been converted into invested capital.

Net profit (earnings, income) or net loss for an accounting period is the increase (decrease) in owners' equity, assuming no changes in the amount of invested capital either from price-level changes or from additional investments and no distribution to the owners. *Revenue* is the increase in net assets of an enterprise as a result of the production or delivery of goods and the rendering of services. *Expense* is the decrease in net assets as a result of the use of economic services in the creation of revenues or of the imposition of taxes by governmental units. *Gains* are increases in net assets other than those resulting from additions to invested capital or from revenues. *Losses* are decreases in net assets other than those resulting from reductions in invested capital or from expenses.

The term "distributions" refers to transfers of assets or of claims to assets to owners.

2

Broad Principles and Historical Limitations

10 In order to make the transition from the postulates as set forth above to the principles developed in this study, some additional steps are necessary. The first is a clear recognition that broad principles must transcend the historical limitations of profits "available for dividends" or "subject to income tax." This is not to say that the effects of dividends and of taxes should be ignored; to do so would ignore a significant part of the environment in which accounting operates. Rather the task is to formulate those principles which will enable us to measure the resources held by specific entities and the related changes *before* consideration of taxes and dividends. The measurements should be independent of the dividend and the tax questions but, at the same time, should facilitate the solution of those questions, as well as of others related to financial position and operating results. Put another way, broad principles of accounting should not be formulated mainly for the purpose of making good, or validating, so to speak, the principles of sound dividend or tax policy. In the foreseeable future, incidentally, another major force will bear more heavily on accounting, namely, the growing interest of employees and their unions, expressed now in financial terms through "fringe" benefits, including pension plans. Unless accountants are forearmed, they could slip into acceptance of accounting "principles" which are not independent expressions of the results of accounting considerations but instead simply validate the policies established in the field of collective bargaining.

Profit and Business Activity

The second step is to bear in mind the major point that profit is attributable to the whole process of business activity, not just to the moment of sale. On this point, George O. May has stated:

Manifestly, when a laborious process of manufacture and sale culminates in the delivery of the product at a profit, that profit

is not attributable, except conventionally, to the moment when the sale or delivery occurred.¹

Recently, William A. Paton has said:

If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production. . . .²

With this point as a basis, the principles necessary to implement it can be formulated.

As we shall see shortly, reliance on "realization" for the recognition of profit does not imply that profit arises only at the moment of sale. Instead it implies something that may or may not be true in a given set of circumstances, namely, that satisfactory results emerge if profit is consistently recognized only at time of sale. Whether or not satisfactory results do in fact emerge needs to be determined for each set of circumstances. Accrual accounting already provides an attitude, a point of view, and a procedure to allocate profit among the appropriate periods. Accrual accounting in essence attempts to reflect the financial effects of business transactions when they occur, rather than at the time of the occurrence of some restricted set of events, such as the receipt or outlay of cash.

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Profit is a function of an increase in the net resources of the business entity. The measurement of the components of profit (revenue, expense, gain, and loss) must accordingly rest on measurements in the area of assets and liabilities.

Not all changes in the assets and liabilities of a business entity are, however, elements in the determination of net profit or loss. Increases in assets, for example, accompanying the issuance of bonds or of shares of stock do not signal revenues, nor does the retirement of bonds or stock indicate expense. Changes of this type are clearly of importance, as everyone recognizes, and therefore are to be recorded and accounted for. Before a calculation can be made of net profit or loss, the status of all the assets and all the liabilities must be reviewed to determine the changes that have occurred. To do otherwise is to walk in the footsteps of the past by recognizing only certain kinds of changes and refusing to recognize other kinds. Such a procedure puts the cart before the horse. The principal task of accounting is to measure the

¹ *Financial Accounting*, Macmillan (New York, 1943), p. 30.

² "Deferred income—a misnomer," *Journal of Accountancy*, Sept. 1961, p. 39.

history of the resources held by economic entities, to measure all of the resources and all of the changes. As this is done, the changes can be classified to show those which enter into the determination of net profit, and those which do not. In addition, the amount of net profit can be further analyzed to indicate, for example, the portion which could prudently or legally be declared as dividends, or that has not yet been reported for tax purposes. As long as certain kinds of changes are ignored, even though the evidence is there, financial accounting will continue to be exposed to the risk of serving merely to validate *policies* as to distributability or taxability of earnings, policies determined mainly by forces outside the control of accountants.

12 The kinds of changes that are involved were described in "The Basic Postulates of Accounting" in connection with the discussion of the postulate on market prices — "accounting data are based on prices generated by past, present, or future exchanges which have actually taken place or are expected to."³ Financial events (transactions) involving at least two accounting entities are almost always recognized in a satisfactory manner. Examples of these transactions are the purchases and sales of goods and services, the lending and borrowing of money, and the receipt and payment of cash. Other changes occur, however, such as movements in the market prices (e.g., replacement costs, or selling prices) of specific goods and services as well as movements in the general level of prices.

If these other changes are to be recognized, how can they be measured? The "imperative" on objectivity states that changes should not be recognized "earlier than the point of time at which they can be measured in objective terms." Even when rephrased in positive fashion to state that changes should be recognized "at the earliest point of time at which they can be measured in objective terms" the "imperative" requires objective measurement.⁴ Accounting, however, already uses a wide range of measures — replacement costs in "cost or market" calculations, index numbers of specific commodities or groups of similar commodities in "dollar-value Lifo," estimates of net realizable values in accounting for by-products, for obsolete or obsolescent goods or equipment and the like, as well as canceled checks and unpaid

³ This is Postulate B-2. The discussion in "Basic Postulates" starts on page 28 of that publication.

⁴ The "imperative" on objectivity is Postulate C-2, set forth on page 7, above. The "corollary" in positive form and related discussion will be found on pages 41-43 of "Basic Postulates."

invoices. The use of this wide range of measures is definitely in accord with the function of accounting and should be integrated into its principles.⁵

The realization of profit. Much attention has been given in accounting to the problem of the allocation of revenues and expenses to relatively short periods of time. Other aspects have not been completely neglected but on the whole they have been subordinated to this central issue of periodic profit determination. In order to reduce the problem to manageable proportions, accounting practice has relied heavily on "realization" as a guide, namely, that revenue arises at point of sale.⁶

The following lengthy passage by George O. May is pertinent for the light it throws on the reasoning behind this guide:⁷

The problem of allocation of income to particular short periods obviously offers great difficulty—indeed, it is the point at which conventional treatment becomes indispensable, and it must be recognized that some conventions are scarcely in harmony with the facts.

Manifestly, when a laborious process of manufacture and sale culminates in the delivery of the product at a profit, that profit is not attributable, except conventionally, to the moment when the sale or delivery occurred. The accounting convention which makes such an attribution is justified only by its demonstrated practical utility.

It is instructive to consider how it happens that a rule which is violative of fact produces results that are practically useful and reliable. The explanation is that in the normal business there are at any one moment transactions at every stage of the production of profit, from beginning to end. If the distribution were exactly uniform, an allocation of income according to the proportion of completion of each unit would produce the same result as the attribution of the entire profit to a single stage.

A number of conclusions immediately suggest themselves: first, that the convention is valid for the greatest variety of purposes where the flow of product is most uniform; second, that it is likely to be more generally valid for a longer than for a shorter period; and third, that its applicability is seriously open to question for some purposes where the final consummation is irregular

⁵ See also Harold Arnett, "What Does 'Objectivity' Mean to Accountants?" *Journal of Accountancy*, May 1961, pp. 63-68.

⁶ This is the version of "realization" used by the Study Group on Business Income in its report, *Changing Concepts of Business Income* (1952), p. 19.

⁷ *Financial Accounting* (1943), pp. 30-31.

in time and in amount. Thus, the rule is almost completely valid in regard to a business which is turning out a standard product in relatively small units at a reasonably stable rate of production. It is less generally valid—or, to put it otherwise, the figure of profit reached is less generally significant—in the case of a company engaged in building large units, such as battleships, or carrying out construction contracts.

These considerations throw a useful light on the problem of the changing uses of accounts; they also explain a tendency which has been notable during the last fifty years in the accounting treatment of large contracts and similar enterprises. In earlier days, when the use of accounts as an indication of earning capacity was not considered, and when conservatism was clearly a virtue, the procedure of treating the gain on even a large contract as arising at the moment of its completion was unobjectionable—any other method might have resulted in taking credit for a profit that might never be earned. In recent years there has developed a much greater readiness to take credit for profits on uncompleted transactions, in order to secure a more useful guide to earning capacity. . . .

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Two points are noteworthy in the passage quoted: (1) the clear recognition that profit is attributable to the whole process of business activity, not just to the moment of sale, and (2) the clear recognition that “realization at point of sale” will give satisfactory results only when the flow of product is reasonably uniform. The first point is always valid because it describes an attribute of business activity which is universally true. The second point makes “realization” a statistical generalization, an assertion about the validity of a convenient method of measurement. This convenient method can produce results which are satisfactory or unsatisfactory at any one point of time or can be satisfactory at one point of time and unsatisfactory at another. This so-called “realization postulate” is therefore in reality a statistical generalization, and can accordingly be applied or not, depending on whether it fits the situation under review.

“Realization” is a term that is used in a variety of ways in accounting. A staff study indicates, for example, that one or more of the following tests have been used to determine if an item is realized or not:

1. It had to be earned.
2. It had to be the result of a conversion brought about in a transaction between the enterprise and someone external to it.
3. It had to be the result of a legal sale or similar process (related to 2, above).

4. It had to be severed from capital.
5. It had to be in distributable form (related to 4, above).
6. It had to be evidenced by liquid assets (related to 5, above).
7. Its effects on the enterprise had to be the subject of accurate measurement or of estimates with a high degree of reliability.

No useful purpose would be served in this study by trying to determine which of these seven tests is valid and which is not. Instead, we note the widespread use of a concept of realization in accounting and that its use implies (among other things) a distinction between realized and unrealized elements of net profit. We will use the term occasionally because its use is so deeply embedded in accounting terminology, but we cannot accept it as an essential feature of accounting because the concept lacks analytical precision. Instead, our concern is with the real elements, the changes in assets and debts, and the related (derived) effect on profit.

Furthermore, principles and procedures based on "realization" are in more or less continual conflict with the postulate of continuity (going concern). "Realization" leads to a shift from the primary objective of accurate reflection of business and economic activity to the sale, which is only one phase of that economic activity.

The determination of profit and the valuation of assets. The formal relationships among the determination of profit, its allocation to accounting periods, and the valuation (pricing) of assets have been worked out in the following sources, among others. The first two are the more complete and sophisticated treatments. The latter two rely heavily on the first two for support:

KENNETH E. BOULDING, *Economic Analysis*. 3rd Edition. 1955. Chapter 38.

JOHN B. CANNING, *Economics of Accountancy*, 1929. Chapters 6-12, inc.

EDWARD G. NELSON, "The Relationship Between the Balance Sheet and the Profit and Loss Statement," *Accounting Review*, April 1942, pp. 132-41. (This article is based on Canning.)

REED K. STOREY, "Cash Movements and Periodic Income Determination," *Accounting Review*, July 1960, pp. 449-54. (This article synthesizes the preceding work on the subject.)

The gist of the analyses that have been made of this problem is that difficulties exist mainly because prices (including interest rates) in the future are not known. If they were known, or could be esti-

mated with a high degree of accuracy, profit calculated by comparing financial position at two points of time would be the same as profit calculated by comparing (matching) revenues and expenses. Either method could be followed, and no distinction between "realized" and "unrealized" would be necessary.

In the face of changing prices, however, the tendency is to defer recognition of profit until sale, or other appropriate point of realization, with the following consequences:

1. Changes in the specific prices of individual items, such as inventories, or plant and equipment, are not recorded until "realized." The total profit is reflected in the period of realization and not apportioned to the periods during which the profit accrued. The balance sheet and earnings statement are forcibly linked by keeping inventories, plant, and equipment at historical cost, even though current costs are higher, so that their valuation is a by-product of the realization rule, as applied to the determination of profit, and not of an independent determination of the asset itself.

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

To visualize the problem in its simplest terms, assume that an item of merchandise is acquired for \$3,000 in Year I and is sold for \$5,400 in Year II. Both at the end of Year I and at date of sale, its replacement cost is \$3,600. Two kinds of questions need to be considered: (1) Is the increment (gain, "profit") of \$2,400 attributable entirely to Year II, to Year I, or to both? (2) Is the increment a gain, or is it partly or wholly something else?

With respect to the first question, we could assert that the total increment of \$2,400 belongs to Year II, a gain of approximately 45% on sales. In line with this assertion the item would be recorded at its cost of \$3,000 at the end of Year I, not at its market (replacement) cost of \$3,600. Alternatively, we could assert that \$600 of the increment belongs to Year I, because the item was bought at a low price and held through a price rise, and that \$1,800 belongs to Year II, a gain of 33 $\frac{1}{3}$ % on sales. Under this assertion, the item would be reflected at \$3,600 at the end of Year I, giving the reader of the balance sheet current information on the inventory.

With respect to the second question, we need to know the behavior of the dollar in its function as a "standard of value" or measuring rod. The behavior of the dollar can be measured indirectly by means of the behavior of prices in general as expressed by an appropriate index number. To the extent that the increment of \$2,400 is attributable to a shrinkage in the dollar (a rise in the price level), it is not a realized profit either of Year I or of Year II, but is instead a mere restatement in terms of the changed dollar of the capital invested in the enterprise.

We observe that it is technically feasible to reflect changes in some assets in a more timely fashion, and thereby give more current information in the balance sheet. In this connection we propose to use a classification that distinguishes among (a) the amount attributable to changes in the dollar (price-level changes), (b) the amount attributable to the acquisition of goods and services prior to their utilization, and (c) the amount attributable to sales in a current market. The horizon of accounting for the results of operations can be expanded in this manner beyond the limits now imposed. At the same time it will continue to be based on objective, verifiable evidence. Its usefulness to management, to investors, and to others can accordingly be greatly increased.

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We also point out that any realization rule that is rigorously applied involves the risk of reporting the wrong amount of profit in the wrong period as specific prices change, and of reporting capital restatements as profit or loss when the general price-level changes. Accounting should avoid both dangers to the greatest extent possible.

Note on the price-level problem. At its meeting on April 28, 1961, the Accounting Principles Board of the American Institute of Certified Public Accountants took the action summarized in the following excerpt from its minutes:

... the Board ... agreed that the assumption in accounting that fluctuations in the value of the dollar may be ignored is unrealistic, and that therefore the Director of Accounting Research should be instructed to set up a research project to study the problem and to prepare a report in which recommendations are made for the disclosure of the effect of price-level changes upon the financial statements. In this study, special attention should be paid to the use of supplementary statements as a means of disclosure.

As the preceding discussion indicates, we are in agreement with the Board that "the assumption in accounting that fluctuations in the

value of the dollar may be ignored is unrealistic. . . .” Furthermore, because a separate study is under way to explore the price-level problem, we have not, in this study, given any detailed attention to its impact on accounting. That detailed attention is given in the study now under way, the results of which should be published in the near future.

Nature of Assets

The concept of assets is related to the concept of economic (i.e., scarce) resources. To come within the purview of "assets," the scarce resources must be assignable to specific entities, must be capable of exchange (transfer), either separately or as part of a related group, and must be expressible in terms of money. These attributes are consistent with the discussion in the preceding study of "The Basic Postulates of Accounting." To be applicable to accounting analysis, however, a further refining of the concept of assets is necessary.

About the turn of the century, Colonel Charles E. Sprague described "assets" as a store of services to be received. Forty years later, Paton and Littleton pointed out that "'service' is the significant element behind the accounts, that is, service-potentialities, which, when exchanged, bring still other service-potentialities into the enterprise."¹ A few years later, Vatter concluded that "assets are economic in nature; they are embodiments of future want satisfaction in the form of service potentials that may be transformed, exchanged, or stored against future events. Whatever means or method is employed to measure assets (cost, price, appraisal, or arbitrary valuation), assets are service potentials, not physical things, legal rights, or money claims."² In 1953, the committee on terminology published its definition:³

Something represented by a debit balance that is or would be

¹ W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards*, 1940, p. 13.

² W. J. Vatter, *The Fund Theory of Accounting and Its Implications for Financial Reports*, 1947, p. 17. Vatter makes the necessary separation between the nature of an asset and the method used to measure it. Chapter 2 of Vatter's *Fund Theory* contains an excellent discussion of the problem of terminology, and is especially incisive in its analysis of other definitions of "asset."

³ American Institute of Certified Public Accountants, *Accounting Terminology Bulletin No. 1*, "Review and Résumé," p. 13, par. 26.

properly carried forward upon a closing of books of account according to the rules or principles of accounting (provided such debit balance is not in effect a negative balance applicable to a liability), on the basis that *it represents either a property right or value acquired or an expenditure made which has created a property right or is properly applicable to the future.* Thus, plant, accounts receivable, inventory, and a deferred charge are all assets in balance-sheet classification. (emphasis added).

The Committee on Concepts and Standards of the American Accounting Association stated that “assets are economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service-potentials available for or beneficial to expected operations.”⁴

Definition of Assets

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For brevity, then, the following definition of assets will be employed in this study: Assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction.

The adjectives “expected” and “future” are used to convey the notion that some degree of uncertainty attaches to all assets with respect to the actual emergence of the benefits. The uncertainty may be minimal, as in the case of holdings of cash or of U. S. Government bonds. It may be considerable, as in the case of the so-called “intangibles.”

The adjective “economic” is used to indicate that the benefits in view are scarce and therefore possess some exchange value, now or in the future. The benefits which constitute the essential element in “assets” may conceivably not be worth very much. If, for example, the “out-of-pocket” costs of operating a piece of equipment exceed the revenues it produces, the equipment is worth only its scrap (salvage, secondhand) value. This, however, is a problem of measurement. The point of emphasis here is simply that “high-cost” resources may still be “economic” resources, and therefore qualify as assets.

The term “transaction” in the definition refers to the event that brought the asset into the entity; “current or past” is used to exclude “future.” For example, a piece of equipment already acquired and in

⁴ “Accounting and reporting standards for corporate financial statements—1957 Revision,” *Accounting Review*, Oct. 1957, p. 538.

use usually represents an asset, but equipment which, according to present plans, is to be acquired next year does not constitute an existing but merely a budgeted asset.

The apparent ability to render future economic benefits is the attribute which makes resources valuable; that which is incapable of rendering future benefits under any set of conditions has no value and is therefore not an asset. Accordingly, the asset status of a resource is usually temporary. Most assets are capable of providing only a limited quantity of economic services or are capable of providing economic services for only a limited period of time. When those services have been dissipated or the time has elapsed, the asset status expires.

An enterprise may retain an object whose economic services appear to have been exhausted but which may be given new economic life and, therefore, new value as a result of repair, overhaul, or other form of rejuvenation. If such a resource requires frequent periodic rejuvenation, its economic usefulness and its value may become exhausted at the end of each period.

Asset with zero value. An example of this limiting case will help clarify the concept of "economic benefit." Assume that a drill press is inoperative now but can be restored to service by appropriate repairs costing \$500, after which it can produce 10,000 units of work. The lowest cost for which these 10,000 units of work can be done by any known and available alternative is \$500. The drill press has a net value, before repairs, of zero, yet it is capable of rendering services *at a price*. But this is true in virtually every case—any unit of plant or equipment requires some cost to make it operative. In the usual case, however, the benefits to be derived are worth more than the additional costs to be incurred to obtain them. As a result, the item has a positive value which is conventionally recorded on a net basis (i.e., the excess of the benefits to be derived over the future cost of obtaining them). The asset with zero or nominal value is simply the special case in which the benefits and costs (both future) are equal.

Asset Forms

The forms in which assets exist and the natures of the economic services which assets are capable of providing are extremely diverse. Some assets are in the form of cash or claims to cash whose economic usefulness lies in its function as a store of value and as a medium of exchange. Some assets, such as materials and supplies, are represented

by tangible objects whose physical substance is ordinarily utilized. Materials will be physically transformed into a finished product and finished product will be transferred to customers in exchange for cash and claims to cash. Other assets, such as plant and equipment, have tangible existence but are utilized in obtaining shelter, mechanical assistance, and the other economic services which they are capable of providing. Even when such assets are no longer capable of rendering valuable services, their physical substance may be virtually unchanged. Other assets, such as unexpired insurance, patents, and goodwill, have no tangible existence. The future services to be derived from them may be the result of some contractual arrangement, other legal right, or perhaps some unique economic characteristic. Organization costs and research and development costs also fall within the class of assets, even though they have no tangible existence, because they create or embody future economic benefits. Bond discount, however, which is frequently grouped with assets in published reports (often as a "deferred charge") possesses none of the attributes of an asset under the criteria set forth above, nor under any of the definitions cited, except possibly that of the committee on terminology of the American Institute of Certified Public Accountants.⁵

⁵ Bond discount is discussed more fully in the section on "Measurement of Liabilities," pp. 39 to 41.

Measurement of Assets

Because the value of assets, indeed their existence, depends upon the future economic services they are capable of rendering to the business enterprise, the dollar amounts identified with assets should be related to those anticipated benefits. In other words, the problem of measuring (pricing, valuing) an asset is the problem of measuring the future services, and involves at least three steps:

1. A determination if future services do in fact exist. For example, a building is capable of providing space for manufacturing activity.

2. An estimate of the quantity of services. For example, a building is estimated to be useable for 20 more years, or for half of its estimated total life.

3. The choice of a method or basis or formula for pricing (valuing) the quantity of services arrived at under 2, above. In general, the choice of a pricing basis is made from the following three exchange prices:

- (a) A past exchange price, e.g., acquisition cost or other initial basis. When this basis is used, profit or loss, if any, on the asset being priced will not be recognized until sale or other transfer out of the business entity.
- (b) A current exchange price, e.g., replacement cost. When this basis is used, profit or loss on the asset being priced will be recognized in two stages. The first stage will recognize part of the gain or loss in the period or periods from time of acquisition to time of usage or other disposition; the second stage will recognize the remainder of the gain or loss at the time of sale or other transfer out of the entity, measured by the difference between sale (transfer) price and replacement cost. This method is still a cost method; an asset priced on this basis is being treated as a cost factor awaiting disposition.

- (c) A future exchange price, e.g., anticipated selling price. When this basis is used, profit or loss, if any, has already been recognized in the accounts. Any asset priced on this basis is, therefore, being treated as though it were a receivable, in that sale or other transfer out of the business (including conversion into cash) will result in no gain or loss, except for any interest (discount) arising from the passage of time.

The relative merits of these three bases are discussed in the remainder of this chapter in terms of specific examples and applications. It should be clear at this point that the proper pricing (valuation) of assets and the allocation of profit to accounting periods are dependent in large part upon estimates of the existence of future benefits, regardless of the bases used to price the assets. The need for estimates is unavoidable and cannot be eliminated by the adoption of any formula as to pricing.

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For the purposes of measurement, all assets can be classified according to the ease or difficulty with which the relationship to anticipated benefits can be established. One such classification is the division into (a) assets in the form of money or claims to money, and (b) all other assets.

Money or claims to money. As a general rule, the valuation of these assets should be based on the amount of cash into which they will be converted, that is, their discounted future exchange prices. Cash itself, whether represented by bank deposits or coins and currency, is measured by count and summation. Domestic holdings are then valued at their face amount; convertible foreign holdings are translated into the domestic equivalent.

Receivables (accounts, notes, loans, advances generally) constitute monetary assets whose value is measured ideally by the present (discounted) value of the future cash receipts to be derived from them. For the sake of accuracy, a rate of interest (discount) should be explicitly employed in calculating the present value of long-term receivables. The use of the market (effective) rate in force at the date the receivable was acquired will result in a recognition of the amount and rate of interest actually being earned by the company under the contract entered into.¹ In the case of short-term receivables, the period

¹ See the discussion of long-term liabilities on page 39, for an extended discussion of this point.

of time until collection is typically so short that the force of interest (at the rates that have prevailed in this country in recent years) may be ignored. Accordingly, short-term receivables are usually measured by the net amount expected to be collected, after making allowance for uncollectibles, cash discounts, etc.

Investments in marketable securities having known maturity values and dates and held as a secondary cash reserve may be valued along similar lines, but since they may be converted into cash momentarily their current market price is usually more significant as a measure of their worth to the enterprise.

Where securities of this class will be converted into cash by resale rather than by redemption at maturity, as in the case of shares of stock, they should be measured by their current market price.

The measurement of marketable securities at current market price offers several distinct advantages:

1. Current market price represents objective information with respect to the amount of cash into which the securities may be converted. If current market price is used consistently the reports of operations covering periods during which temporary investments are held will throw some light on results of decisions to hold or to sell them. If, for example, market price rises in one period and declines in the next, while securities are held, the loss sustained by failure to sell at a higher price will be revealed.²

2. The measurement of marketable securities at current market price eliminates the anomaly whereby otherwise identical and interchangeable securities are carried at different amounts merely because they were acquired at different prices.

Other assets: general considerations. The conversion into cash of assets other than money and claims to money is usually indirect and therefore characterized by more uncertainty than the money items. As a consequence and with some notable exceptions, their valuation is based on past or present rather than future exchange prices.

Cost is an exchange price, a forgoing, a sacrifice made to secure benefit. In financial accounting, the forgoing or sacrifice at date of acquisition is represented by a current or future diminution in cash or other assets.

The measurement of these other assets is frequently made by the

² The use of current market price in this connection is permitted by Postulate C-2 on objectivity. See page 7.

process of aggregating the costs of acquiring them and of bringing them to their existing condition and location. This procedure has two important attributes. One, each acquisition cost represents the evaluation of the market at that time and therefore represents *prima facie* evidence of an objective (i.e., unbiased, impersonal) appraisal of the economic value of the assets. And two, that appraisal is supported by one or more overt transactions and is therefore capable of independent verification. As emphasized by W. A. Paton, "cost is significant primarily because it approximates fair value at date of acquisition. Cost is not of basic importance because it represents an amount paid; it is important as a measure of the value of what is acquired." "Thus, it is really values that are the basic data of accounting, and costs are important only because they are the most dependable measures of initial values of goods and services flowing into the enterprise through ordinary market transactions."³

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Assets may be acquired by donation or a similar means without incurring costs directly, as where communities supply land or plant in exchange for a promise to employ a given number of people for a specified period of time. Assets may also be acquired in exchange for shares of stock or other equity in the enterprise. In these cases, costs in the sense described above do not exist. Accordingly, the initial measurement of these assets must be based on other evidence, such as current market price or appraisal. The essential point is that the existence of an asset (future economic services) is independent of the means by which it was acquired although the means (e.g., for cash or for debt) may be used as a measure of the size of the services acquired.

Subsequent to acquisition, events may demonstrate that acquisition cost or other initial basis no longer represents a useful measure of future benefits for a particular asset. As obvious examples, oil or other valuable natural resources may be discovered on enterprise land holdings acquired initially for other purposes or unforeseen obsolescence of a product or process may occur. In cases of this type and of others in which initial basis is no longer a useful or representative measure a different basis should be adopted. Where they exist and are determinable, current market prices may be used, whether they are higher or lower than acquisition cost or other initial value. Market price is

³ The first passage quoted is from "Cost and Value in Accounting," *Journal of Accountancy*, Mar. 1946, p. 193; the second is from "Accounting Procedures and Private Enterprise," *ibid.*, Apr. 1948, p. 288.

an exchange price which is ordinarily independent of the plans or expectations of the individual entity. It therefore represents a neutral, objective evaluation of economic benefits. Since people act in the present and the future, and not in the past, current market price is preferable to past, all other things being equal. Current market price is also superior to past market price (acquisition cost) as a measure of the “forgoing” or “sacrifice” involved in the use or other disposition of the asset.

If reliable current market prices are not available for the specific asset under review, at least two alternative methods of measurement may be used. One is the use of an index number specially designed to measure the movements in the prices of a specific item or group of similar items, such as the available indexes of various commodity prices or of construction costs. The other alternative is the use of an independent appraisal of the specific item involved.

Inventories. Inventories are destined for sale to customers in one turnover period, a period which for many commodities is relatively short. As a consequence, whenever the ultimate proceeds from sale can be established, the data should be recorded in the accounts. As a specific case in point, inventories which are readily salable at known prices with negligible costs of disposal, or with known or readily predictable costs of disposal, should be measured at net realizable value (i.e., anticipated sales proceeds less costs of completion and disposal). These conditions are most likely to exist in the cases of certain agricultural products and the products of certain extractive industries. Cotton, wheat, corn, oats, rye, soy beans, barley, raw sugar, coffee beans, gold, silver, copper, and crude oil are but a few of the products which are already accounted for in this manner. By-products of all types are also commonly measured and accounted for at net realizable value.⁴

This procedure will have the result of assigning most if not all of the change in resources and the related profit or loss to the period of production (or other activity) when the actual effort was made. While it leads to the same result, it differs in attitude from the one expressed

⁴ For convenience throughout the discussion of inventories, a perpetual-inventory system is assumed, so that “cost of goods sold” is merely the result of a transfer from the inventory account to expense, and not the result of a separate calculation of a residual, as under the periodic-inventory method of calculation. The discussion could be restated in terms of a periodic-inventory system. The results, however, are the same under either procedure.

in Chapter 4 (Inventory Pricing) of *Accounting Research Bulletin No. 43*. That source recognizes the acceptability of stating inventories above cost “only in exceptional cases,” specifically, “precious metals having a fixed monetary value with no substantial cost of marketing” and “other exceptions” which can be justified by “inability to determine appropriate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability” (p. 34).

28 Instead of classifying this procedure as “exceptional” we find it to be in keeping with the major objectives of accounting. Measurement of inventories at net realizable value is the preferred method whenever the measurement is objectively determinable. Historical cost is far from a satisfactory basis for pricing inventories because it rarely reflects either present utility or future benefits. Its alleged major advantage in the case of inventories is its definiteness. But where a more useful measure (e.g., net realizable value or current replacement cost) is available and is also capable of close estimate and prediction, it should take precedence over historical cost. In centering their attention on “verification,” accountants frequently select less useful instead of more useful procedures. Verifiability (definiteness, objectivity) is a necessary condition for the use of any procedure in any rational accounting, but it is not a sufficient condition. Other attributes need to be considered and a choice made from the array of all procedures which meet the test of objectivity.

In many cases, however, inventories cannot satisfactorily be priced at net realizable value (a future exchange price). Even where selling prices are determinable, the amount which can readily be sold, the length of time required in order to accomplish the sales, and the selling and disposal costs are apt to be uncertain and incapable of adequate verification. Under these circumstances, the treatment of inventories as though they were receivables is not justified. Instead, they are still in the category of “costs awaiting disposition.” The choice, therefore, lies between a past and a present exchange price.

The consistent use of acquisition cost (a past exchange price) as a valuation basis results in the deferral of any gain or loss that may be accruing until the item is sold or otherwise disposed of. As a consequence, inventory valuations are out of date and relate not to the present or to the future but to the past. Furthermore, as soon as two or more items in the inventory are acquired at different dates, the acquisition costs do not even relate to the same point of time.

Since the use of a future exchange price is ruled out as inapplicable in these cases, and a past exchange price as defective, we are left

logically with the possibility of using a current exchange price, or replacement cost. The use of current (replacement) cost as the basis for inventory measurement eliminates the need for any assumption as to the flow of actual costs incurred. The current cost of inventories is the same whether the related underlying records and tax returns are based on an assumption of a last-in, first-out flow of actual costs incurred, a first-in, first-out flow, a weighted average, or specific identification. Measurement of inventories at current cost means that goods sold (expense) should also be measured at current cost, thereby accomplishing the avowed purpose of the last-in, first-out method. It also means that inventory on hand will be measured at a figure which is at least as useful, if not more useful, than the one derived by the use of first-in, first-out.

The relevance of current (replacement) cost to a going concern is underlined whenever the enterprise continues to manufacture or purchase the items contained in its inventory. This behavior creates a forceful presumption that current (replacement) costs represent at least the minimum economic value of those items to the enterprise.

The use of current (replacement) cost has the further advantage of introducing a clean-cut distinction in the accounts between profit from holding an item through a price rise or fall, and profit from "operating margins," that is, the difference between sales price and current (replacement) cost of the goods sold. To record "holding" gains or losses completely would require the adjustment of each item of finished goods to current cost at the moment of sale, and of unsold items of all inventory classes (finished goods, work in process, materials and supplies) at the end of each accounting period. In this manner, the transfer from finished goods to cost of goods sold would always be at the most current cost, and the unsold items would also appear at the most current cost in the balance-sheet. This procedure can be simplified in most cases, however, by adjusting the finished goods account to current cost periodically at the end of each month or calendar quarter, and not at the moment of sale. This adjusted figure would then be used during the succeeding month or quarter to cost out all goods sold during that period. The resultant inaccuracy in the separation of "holding" and "operating" gains or losses would not be significant unless costs were changing rapidly and substantially.⁵

⁵ The excellent term "holding gains or losses" is taken from E. O. Edwards and P. W. Bell, *The Theory and Measurement of Business Income*. 1961.

This “holding” gain or loss should be included as an integral part of the profit calculation, classified along with the related gain or loss on goods sold, for the following reasons:

1. The changes in prices have occurred, they are objectively determined, and the accounting entity is clearly affected. Furthermore, “ultimate realization” is reasonably assured because current cost is below current selling price by a normal profit margin. As a result, no useful purpose is served by delaying recognition of the changes.

2. The separate disclosure of “holding” and “operating” gains (losses) is of significance in analyzing and interpreting the results of operations. This disclosure is most readily accomplished by inclusion of the data in the formal records and financial statements.

3. The amount of the “unrealized” element is of significance in connection with income taxes and may be with respect to the legal aspects of dividend policy. The disclosure of this amount is readily accomplished by reporting the extent and the effect of the adjustment made to beginning and ending inventories.

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Comparison with current procedures. According to Chapter 4 of *Accounting Research Bulletin No. 43*, “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.” However, “a departure from the cost basis of pricing the inventory is required where the utility 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. The measurement of such losses is accomplished by applying the rule of pricing inventories at *cost or market*, whichever is lower” (pp. 30-31). “. . . the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) . . .” (p. 31). “The term *market* is . . . to be interpreted as indicating utility on the inventory date and may be thought of in terms of equivalent expenditure which would have to be made in the ordinary course at that date to procure corresponding utility. As a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction” (p. 31).

Exceptions to the “general guide” are recognized which place re-

liance on net realizable value. "Replacement or reproduction prices would not be appropriate as a measure of utility when the estimated sales value, reduced by the costs of completion and disposal, is lower, in which case the realizable value so determined more appropriately measures utility. Furthermore, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower" (p. 31).

By contrast with the emphasis in Chapter 4 of *Accounting Research Bulletin No. 43* on acquisition cost and on the lower of acquisition cost or market, we extend the use of current (replacement) cost to the cases where it exceeds acquisition cost. The rationale for our position is identical with that cited in support of the use of replacement cost when it is lower than actual cost, namely, that "as a general guide, utility is indicated primarily by the current cost of replacement of the goods as they would be obtained by purchase or reproduction" (p. 31).

The "cost or market, whichever is lower" rule has been defended on the grounds that (1) it results in the recognition of "a loss of utility" in the period during which that loss takes place, and (2) it prevents the measurement of inventory items at amounts which are in excess of the amount which can be recovered in the future when the inventory items are used or sold. The rule has long been criticized, primarily on the basis of its inherent inconsistency. If current replacement cost is objective, definite, verifiable and more useful when it is lower than acquisition cost, it also possesses those attributes when it is greater. By the use of current replacement cost, a change in "utility" is recognized in the period when the change takes place. And inventory items would still be measured at amounts which are below current selling prices by the amount of the operating margin (gross profit).

Some have argued that the recognition of gains in a manner similar to that for losses is not acceptable because of (1) the need for "conservatism" (i.e., the need to recognize losses but not to anticipate gains), and (2) the absence of "realization." Conservatism of this type is, however, short-lived. The recognition of a loss this period and the accompanying reduction in reported profit inevitably means an offsetting increase in some future period. More serious, however, is the incompatibility of this type of conservatism with consistency, and the inherent lack of fairness in its application to inventories. The recognition of "unrealized losses" accompanied by the nonrecognition of "unrealized gains" produces information which discriminates in

favor of those acquiring as opposed to those disposing of equities. Assuming that the market value of an enterprise's securities are affected to some extent by its financial position and the results of its operations as reported in its financial statements, consider the effect on an enterprise of a substantial "unrealized loss" on marketable securities (recognized by application of the rule of cost or market, whichever is lower) and an unrealized but unrecognized gain of the same amount on inventories.

The absence of realization is no bar to the use of current (replacement) costs for inventories. The "cost or market" rule has served a useful purpose in this regard. It has trained accountants to detect, measure, and evaluate current (replacement) costs so that an extension of their use becomes both practical and natural.

Plant and equipment. "Plant and equipment" refers to those tangible assets having limited useful life and held by the business enterprise for the purpose of facilitating the creation and distribution of goods and services. The useful life of plant and equipment is limited by physical factors, such as deterioration resulting from utilization and the action of the elements and by functional factors, such as obsolescence and inadequacy. Accordingly, with utilization and the passage of time, there is a diminution in the remaining useful services which items of plant and equipment are capable of providing. This diminution when expressed in financial terms is referred to as depreciation.

As in the case of newly acquired assets (other than money and claims to money), the initial basis of measurement for items of plant and equipment is acquisition cost or the equivalent. All items of plant and equipment that are serviceable should be reflected in the accounts and included in any statement of financial position. Items that are no longer in service should be removed from the accounts, or classified separately as idle plant or equipment.

The "economic benefits" that these assets provide take the form of a stream or series of services, such as shelter in the case of buildings, transportation in the case of automotive equipment, and lifting power in the case of cranes and hoists. Even though the investment in these assets takes the form of an investment in a physical object, an implement, it is the services that the object is capable of providing that are sought after and acquired. The physical object itself is a scarce good, thereby giving rise to an exchange price, as well as a basis for classifying and measuring it initially in the accounts. The services

that the object provides are also scarce, providing a basis for treating them in the accounts in a manner similar to the treatment of other (scarce) goods and services. At the level of measurement, then, we are concerned primarily with the measurement of scarce services, those that have been used up, and those that still remain.

The root of the special difficulties in measuring plant and equipment lies in the distinction, described above, between the physical object itself and the services it is capable of providing. The market for the physical object is a present market; the market for the services is a future market, except for the services immediately available. Take the case of an office building: if buyers and sellers could forecast accurately their need for office space and its availability at all relevant times in the future, the office building would have a current (market) value equal to the present (discounted) value of the rents (less out-of-pocket expenses) on the offices it contains. But the forecasts that have to be made of the market for future office space are the subject of a wide margin of error precisely because they deal with the future, whereas the market for office buildings is an existing market. As a result, practical considerations focus on the instrumentality (the office building), not on the economic benefits (office space provided by the building). And accounting similarly focuses on the instrument, and not on the benefits it is capable of providing.

Except where the results of some formal procedure, such as an appraisal or a quasi-reorganization, have been incorporated in the records, these assets are almost always carried at acquisition cost, because, in the first place, these assets are acquired and held to be used up, not to be sold as stock-in-trade. They do not represent potential revenues, as do the inventories, and therefore are not amenable to treatment as though they were receivables. As a consequence "net realizable value" has no relevance, except as a measure of scrap or secondhand value; the problem of allocating revenues correctly to periods, clearly so important in connection with inventories, does not arise here. In the second place, many (though by no means all) of these assets are highly specific so that they cannot be transferred readily to others (again, except as scrap or salvage). The consequence here is that a "current market price" does not exist for most of these cases, even if we were inclined to use it.

To continue to carry these assets at acquisition cost does have the unavoidable consequence, however, of combining (a) the gains (losses) attributable to changes in prices between acquisition and usage with (b) the gains (losses) attributable to operations in a cur-

rent market. For example, if a drill press cost \$10,000 five years ago and has a replacement cost, new, of \$15,000 (general price level remaining unchanged), the fact that the enterprise is operating with low-cost equipment (relatively speaking) will show up in enhanced profits from operations. The fact that part of the profit is the result of "buying cheap" and "using dear," so to speak, will not be revealed. To reveal this fact requires the use of the current (replacement) cost of the services rendered by these assets and the separate classification of the related gain or loss. This procedure is already used extensively in the internal accounting reports of large industrial companies. Its extension to the external reports is worth serious consideration.⁶

In the external reports, plant and equipment should be restated in terms of current replacement costs whenever some significant event occurs, such as a reorganization of the business entity or its merger with another entity or when it becomes a subsidiary of a parent company. Even in the absence of a significant event, the accounts could be restated at periodic intervals, perhaps every five years. The development of satisfactory indexes of construction costs and of machinery and equipment prices would assist materially in making the calculation of replacement costs feasible, practical, and objective.

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Depreciation accounting. Depreciation accounting is the process of allocating the cost or other basis of the services rendered by items of plant and equipment to the products or periods that used those services. Depreciation for any given accounting period, then, is the cost, or other basis, of the services used up in that period.

Whatever the difficulties may be that are attendant upon making these calculations, the allocations should be made in a systematic and rational manner. Different methods of estimation are appropriate in different circumstances. The basis for adopting a particular method of estimation for a given asset should be its ability to produce an allocation reasonably consistent with the anticipated flow of benefits from the asset. Accordingly, the "undepreciated cost" should reflect a reasonable estimate of unused service units.

The preceding discussion of depreciation appears to be compatible with the definition adopted by the committee on terminology of the American Institute of Certified Public Accountants.⁷

⁶ E. O. Edwards and P. W. Bell discuss this problem at some length in *The Theory and Measurement of Business Income*. 1961.

⁷ *Accounting Terminology Bulletin No. 1*, "Review and Résumé" (1953), p. 25.

For comparison, the committee's definitions are given below:

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.

Land. In general, urban land is capable of rendering its services for an infinite period of time. Hence, neither the utilization of land nor the passage of time causes a diminution in the amount of future services which land is capable of providing. Accordingly, its value subsequent to the date of acquisition is not diminished because of expired services.

Where the utilization of land involves the extraction of natural resources, however, their amount is limited. The diminution of natural resources by extraction or dissipation is known as depletion. In measuring the carrying value of such lands subsequent to the date of acquisition, the estimated amount of accumulated depletion is deducted from the cost or other basis before depletion. The measurement of the amount of accumulated depletion at any point of time requires the allocation of carrying value before depletion between (a) the resources which have thus far been extracted and (b) the resources and any other services which remain available for utilization.

Agricultural land poses a problem of maintaining its fertility and hence its ability to render valuable services indefinitely. Historically, the usefulness of certain lands for agricultural purposes has been exhausted or seriously impaired. Where this condition is likely to occur, accumulated depletion should be recognized in the same manner as in the case of other natural resources. With modern scientific farming methods, however, the fertility of agricultural land may be maintained, if not improved. Where that is the case there is no diminution of future services and the measurement of the value of those lands does not involve an estimate of accumulated depletion.

In all these cases (urban land, natural resources, agricultural land) the use of acquisition cost as a basis of measurement frequently results in the presentation of out-of-date information in published financial statements. Accordingly, serious consideration should be given to a

restatement of these items in current terms at reasonable intervals (perhaps every five years). If this is done, the financial statements should disclose the date of the last restatement. The related increase (decrease) in owners' equity should be separately classified.

The "intangibles." The preceding discussion of plant and equipment is also applicable to patents, copyrights, research and development costs, goodwill, and the like. In one sense, these items represent assets in their "purest" form because their value depends directly on "future economic benefits" and not indirectly on some physical implement or tool that is capable of providing benefits. Their very "purity" as assets (services) makes them difficult to deal with, however, because current or future exchange prices for them often do not exist. The consequence is that these items are notoriously difficult to evaluate and therefore should probably be carried at acquisition cost in the absence of compelling evidence that their value is markedly different. "Intangibles" of limited term should be amortized as production cost or expense over their estimated service lives. Unlimited-term items should continue to be carried as assets, without amortization.

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Investments. The reference here is to investments other than marketable securities held as a secondary cash reserve. Temporary holdings were discussed in a preceding section (see page 25).

A separate research study is now under way in the Accounting Research Division of the Institute on the subject of "intercorporate investments" which will consider virtually all of the important problems that arise in accounting for investments generally. We will therefore not comment at length on this topic but instead observe that investments (a) represent an interest in some other entity's operations and (b) are usually held for the long term and not for sale or other liquidation in the foreseeable future.

The Nature of Liabilities and Owners' Equities

The liabilities of a business enterprise are its obligations to convey assets or perform services, obligations resulting from past or current transactions and requiring settlement in the future. The term "obligations" connotes a claim or series of claims against the business enterprise, each of which has a known or reasonably determinable maturity date and an independent value which is known or reasonably measurable. Settlement of a specific obligation may involve payment in cash or in other assets, or the performance of services. Ultimate settlement may be postponed by the substitution of another obligation. At the option of the obligee (the creditor), the liability may on occasion be settled by conversion into an ownership interest. Neither the maturity date nor the value of the obligation needs to be known precisely for the obligation to constitute a liability of the enterprise. Further, the specific party with whom ultimate settlement must be made need not be immediately identifiable. For example, warranties are liabilities which may require settlement within a time period which must be estimated, in an amount which cannot be estimated with complete accuracy, and to persons who are not known at the time the warranty creates an obligation.

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The preceding definition and comments are compatible with the legal attitude as summarized in *Corpus Juris Secundum*, vol. 53, p. 17:

The term (liability) has been variously defined as meaning amenability or responsibility to law; . . . the state of being bound or obliged in law or justice to do, pay, or make good something; . . . the state or condition of one who is under obligation to do at once or at some future time something which may be enforced by action. (*White v. Green*, 105 Iowa 181, 74 N.W. 929 adds: "It may exist without the right of immediate enforcement.") It is a condition which creates a duty to perform an act.

The owners' equity is represented by the amount of the residual interest in the assets of an enterprise. The owners' equity is distinguishable from liabilities on two grounds: first, the amount of the owners' equity is residual in nature while the maturity values of liabilities are independently determined. Whenever a change in assets is not exactly offset by a change in liabilities, or *vice versa*, the difference is automatically reflected in the owners' equity as the residual interest. Second, liabilities are in a continuous and irresistible process of maturing while the owners' equity matures only at the volition of the owners of the business enterprise or their representatives or upon ultimate liquidation. Thus, liabilities are obligations, the amounts and maturities of which are not solely within the control of the business enterprise. The owners' equity does not constitute an obligation because, ordinarily, the business enterprise is not legally or equitably compelled to provide payments or services to owners other than by the decision of the owners or their representatives. Only in the final stages of liquidations, as owners' equities may be converted into obligations of known amounts with impending maturities, do they completely disappear as a class of interests having separate and distinct significance from that of liabilities.

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In the normal course of events in a business corporation, for example, the declaration of a cash dividend effects a transfer of the amount of the dividend from stockholders' equity to liabilities. The declaration creates an obligation of fixed amount and known maturity, an obligation which is no longer within the control of the business enterprise. On the other hand, the declaration of a "stock dividend" (i.e., issuance by a corporation of its own shares pro rata to its shareholders without new consideration) does not result in a transfer from stockholders' equity to liabilities. The declaration of a stock dividend does not create an obligation requiring settlement by the payment of cash or other assets or the delivery of agreed-upon goods or the performance of agreed-upon services. The issuance of additional shares without new consideration merely constitutes an increase in the number of shares which represent total stockholders' equity without affecting that total.

Liabilities sometimes exist in a form which may be converted into owners' equity at the option of the obligee. For example, bond indentures may provide that under certain prescribed conditions bonds can be exchanged for shares of stock at the option of the bondholder. Until conversion occurs, these bonds are liabilities. Upon conversion there is an increase in stockholders' equity and a reduction of liabilities.

Until actual exchange, the bonds have a known maturity date and maturity value.

Measurement of Liabilities

To measure a liability is to determine the “weight” or the “burden” of the obligation on the balance sheet date. This “burden” is the lowest amount for which the obligation could be effectively discharged. If, for example, payment in cash now will discharge the liability, that amount of cash is the measure of the liability, even though in fact payment is delayed. If the creditor will not or cannot accept cash now in discharge of the liability, the appropriate amount is that sum which, if invested now (e.g., in a sinking fund), will provide the sums needed at maturity, even though in fact no explicit sinking fund or other investment device is actually used.

From the standpoint of measurement, two broad types of liabilities can be distinguished. The one type calls for settlement in cash; the other type calls for settlement in a form other than cash.

The amounts of those obligations calling for settlement in cash should be measured by the future payments, discounted to the present by the use of a market (yield, effective) rate of interest. Where short-term obligations explicitly recognize the element of interest, as in the case of certain promissory notes, that factor should be recognized in the measurement of the liability. Where the short-term obligations do not explicitly recognize the element of interest, as in the case of trade accounts payable, the force of interest is ordinarily negligible because the span between the future payment and the present measurement is short.

In the case of long-term liabilities, the force of interest is significant and should be recognized. Hence, in the case of long-term debt, the liability is properly measured by the present (discounted) value of all future payments to be made under the contract. These future payments include periodic “interest” payments and all “principal” payments, whether in installments or in a lump sum at maturity. Ordinarily the pertinent rate of interest for determining present value is the yield rate of interest at the date of issue (also called the effective rate or market rate), which may differ from the nominal or coupon rate in the contract itself.

Where the resultant present value differs from the amount due at maturity, the amount of the liability is measured by deducting the amount of the “discount” from the maturity payment or adding the

amount of the "premium" to the maturity payment. A "discount" does not represent an embodiment of future economic benefits and accordingly cannot constitute an asset. A "premium" has no characteristic which differentiates it from any other part of the liability. It represents an integral part of the amount received (borrowed) in exchange for a contract to make future payments, and is repaid as the provisions of the contract are complied with.

To illustrate, assume that X Co. issues 5% bonds maturing in 20 years, coupons payable semiannually. If the current market rate of interest is $5\frac{1}{2}\%$, the bonds can be offered to yield that rate, in which case they will be priced at a fraction under 94. Alternatively, if they are put out for bid, the highest price offered will be slightly under 94. In either case, the rate of $5\frac{1}{2}\%$ is the factor which equates the issue price and the stream of cash payments promised in the bond contract. The discount of six points below par is simply a technical device for relating issue price to principal amount.

40 This yield or market rate of $5\frac{1}{2}\%$ measures the financial cost to the issuer and is therefore the appropriate rate to use in accounting for what has happened. The use of this rate will not, however, indicate whether the borrowing continues to be advantageous. If, for example, interest rates should rise to 6%, the market price of this bond issue should fall, indicating that the issue of bonds at $5\frac{1}{2}\%$ was advantageous to the borrower. If, on the other hand, interest rates have fallen to 5%, the market price should rise, indicating that the original issue was disadvantageous. The related "gain" or "loss" can be realized (from the standpoint of the ownership interest) by paying off the issue at the market price, or, if the issue cannot be paid off in this manner, by investing an equivalent amount in other securities at the market rate. If (a) the bonds are callable before maturity, (b) interest rates are dropping and (c) the issuer does not wish to use cash on hand, he can borrow new money at the lower rate to pay off the old debt. In such a case, the loss is the sum of the call premium and the unamortized discount on the old issue. It is also based upon the results of a completed transaction and can accordingly be so reflected in the accounts. The new issue should therefore be carried at its own issue price since that price reflects the cost of borrowed money in the market situation prevailing at that time.¹

We conclude that the accounting practice of using the yield

¹ This conclusion differs from the one expressed in Chapter 15 of *Accounting Research Bulletin No. 43*, "Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded." In that chapter the

(market) rate at date of issue until a bond issue is retired is sound because it reflects the interest burden which the issuer is in fact bearing. It does not, however, reflect whether or not the burden is too high or too low in terms of the changes which may have taken place in interest rates. For that purpose a supplementary analysis is necessary.

Liabilities calling for settlement by the delivery of goods or the performance of services ordinarily arise from deposits or other advances by customers for goods or services to be supplied later. Liabilities of this type should be measured by the amount of the deposit or advance which ordinarily is equal to the agreed-upon exchange price of those goods and services. For example, the obligations resulting from the collection of subscriptions by a magazine publishing enterprise or the collection of premiums by an insurance company should be measured by the amounts of the advance collections. As the magazines are produced and delivered or the insurance coverage provided, revenue should be recognized in the accounts. No profit can accrue prior to the performance of the agreed obligation to produce goods or to perform services.

Measurement of Owners' Equities—Business Corporations

Historically, accounting for stockholders' equities, perhaps more than any other aspect of accounting, has been strongly influenced by legal concepts and statutory provisions.² Financial statements, however, are primarily economic rather than legal documents and, accordingly, an accounting which reflects the basic economic distinctions is paramount.³

committee on accounting procedure expressed the opinion that

- (a) to write off unamortized discount in full in the year of refunding is acceptable.
- (b) to distribute the write-off over the remainder of the original life of the bonds refunded is the preferred method.
- (c) to amortize the discount over the life of the new issue is not acceptable.

² *Accounting Research Bulletin No. 12*. "Report of Committee on Terminology," dated September 1941, contained the suggestion that designations be used "which would make it clear that the balances in this section . . . emphasize the distinction between (1) legal capital, (2) capital in excess of legal capital, and (3) undivided profits." (p. 109.)

³ *Accounting Research Bulletin No. 39*, "Recommendation of Subcommittee on Terminology—Discontinuance of the Use of the Term 'Surplus,'"

In accounting for stockholders' equities, therefore, a fundamental distinction is maintained between *invested capital* and *retained earnings*. *Invested capital* refers to the portion of stockholders' equity which arose from the commitment of assets to the enterprise, including transfers from retained earnings, and which will not be withdrawn or reduced except as permitted by law. *Retained earnings* or *earned surplus* designates the portion of stockholders' equity which arose from operations. The amount of retained earnings is uncommitted in the sense that the board of directors has the power to decide (a) to distribute assets to stockholders as a share of the earnings of the enterprise and thereby reduce the amount of earnings retained, or (b) to designate some part or all of the amount of retained earnings as invested capital.

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A distinction between invested capital and retained earnings has relevance to stockholders. For example, when cash dividends are distributed, stockholders are entitled to assurance that they are based on current or past profits and do not constitute merely a return of some of the cash or other assets originally invested in the enterprise or of previous earnings converted into invested capital. The distinction between invested capital and retained earnings is also significant from the viewpoint of creditors. Invested capital constitutes a buffer against enterprise losses. These losses must exceed the amount of retained earnings and stockholders' invested capital before creditors' equities are impaired.

Invested Capital

Invested capital may be further classified according to source, that is, according to the underlying nature of the transactions giving rise to the invested capital. In this way, invested capital may be identified with transactions involving shareholders (e.g., stock issues, treasury-stock transactions), transactions involving persons other than shareholders (e.g., gifts, subsidies, grants-in-aid), and those restatements which reflect the change in the size of the dollar (price-level changes).

Frequently, the invested capital associated with shares of stock is

dated Oct. 1949, recommended that in describing the components of stockholders' equities, the use of certain legal terminology should be discontinued and that "consideration should be given primarily to the *sources* from which the proprietary capital was derived" (p. 296). This view was reiterated in *Accounting Terminology Bulletin No. 1*, "Review and Résumé," 1953 (p. 30).

classified as *capital stock* and *invested capital in excess of par or stated values of capital stock*. The significance of the amount of capital stock is purely legal in nature. In legal terminology it is usually referred to as the amount of "stated capital." It measures the portion of stockholders' equity which is most directly related to the number of shares of stock issued and which typically cannot be reduced except under restrictive statutory proceedings. Capital stock is subdivided according to those amounts attributable to each authorized class of stock, e.g., the amounts attributable to preferred and to common stock. The amount of each class of stock is usually measured by the aggregate par value of shares issued or the aggregate stated values of shares issued without par value.

Any excess of the amount of consideration received for shares over their stated value is also invested capital, since it represents an integral part of the stockholders' contributions. The terms "capital surplus" or "paid-in surplus" are widely used in state corporation statutes and in the accounting literature to describe this excess. It is surplus in the sense that, although it constitutes a portion of the capital of the business enterprise, it is in excess of the amount of "stated capital" and, accordingly, its reduction is usually subject to a lesser degree of statutory limitation. It is usually classified separately.

The committee on terminology of the American Institute of Certified Public Accountants has urged that ". . . in the balance-sheet presentation of stockholders' equity . . . the use of the term *surplus* (whether standing alone or in such combinations as *capital surplus*, *paid-in surplus*, *earned surplus*, *appraisal surplus*, etc.) be discontinued."⁴ The term, invested capital in excess of par or stated value of capital stock, has been appearing in published financial reports with increasing frequency. This subclassification of invested capital is not necessary but when properly arranged it does permit information of an essentially legal nature to be disclosed.

Retained Earnings (Earned Surplus)

The amount of retained earnings is measured by the cumulative amount of net profits and net losses of the business enterprise, less the amount of dividends and less any amount of retained earnings formally transferred to *invested capital*. A negative balance of retained earnings is often referred to as a *deficit*.

⁴ *Accounting Terminology Bulletin No. 1, op. cit.*, p. 30.

Retained earnings in the broad sense include both realized and unrealized components. A restatement of plant and equipment, for example, from acquisition cost to current replacement cost, after allowance for any change in the price level, is in the nature of an unrealized gain (loss) and should be so classified and described. Thus, if a piece of land acquired for \$50,000 (price level at 100) is now recorded at its current replacement cost of \$100,000 (price level at 160), \$30,000 of the increase is a restatement of the capital originally invested in the land, and \$20,000 is a gain which could be realized by sale or equivalent conversion of the land at \$100,000.

The transfer of amounts from the status of retained earnings to the status of invested capital may be made separately or may be made in conjunction with the distribution to shareholders of additional shares of stock (so-called stock dividend). In either case, the amount transferred loses its identity as having been derived from the retention of earnings, and the stockholders' equity accounts no longer are classified strictly according to source.

Unincorporated Business

The distinction between invested capital and retained earnings is also significant for unincorporated businesses. Whether it is necessary to reflect the distinction in separate owners' equity accounts, however, depends upon the relationship of the owner or owners to the operations of the enterprise. Because there are no statutory restrictions on withdrawals of equity, the distinction between invested capital and retained earnings is not particularly significant to creditors. As one result, owners' equity accounts are usually not classified according to source but, instead, tend to show the interest of each owner at the balance-sheet date.

As the relationship of owners to the financial affairs of the enterprise becomes more remote, however, the corporate pattern becomes more relevant. A business owned by partners, for example, some of whom may not be active in the business or some of whom may be engaged in nonfinancial duties should provide financial information to its owners which is similar in detail to that required for the stockholders of a corporation. There is, however, at least one important additional requirement. Where the equities of partners are not equal and are not evidenced by any common denominator such as shares of stock, information with respect to the equity of each owner should also be available.

Nature of Profit

The net profit (earnings, income) of a business enterprise during any given period of time is the amount of the increase in the owners' equity, assuming no changes in the amount of invested capital during the period either from price-level changes or from additional investments and no distributions of any sort to the owners. The term "distributions" refers to assets (e.g., a dividend in cash or in kind) or claims to assets (e.g., a scrip dividend).

Hence, in the absence of changes in the amount of invested capital, the equities of owners will be increased only if some amount less than enterprise earnings is distributed to them; an enterprise can make distributions to owners in an amount in excess of the amount of its earnings only by contracting their equity; and, if it is desired to maintain the previous amount of the owners' equity, the amount of current earnings is the amount which can be distributed to them. This implies no judgment as to the distribution policy which ought to be followed. Even in the presence of profits, assets may not be in distributable form, and, even if they were, their disposition is a matter for the owners or their representatives to decide.

The earning process is a continuous one, taking place over the entire life of a business enterprise. The need for interim measurements during the life of the enterprise leads to the use of relatively short accounting periods such as the year. Inevitably, this means that allocations between past, present, and future periods must be made and, as a result, measurements of profit during short periods of time are tentative. (Postulate B-4.)

In general, the accounting process must provide more than a measurement of the net amount earned during a period of time. Information about the components of profit is needed as a basis for evaluating the past and forecasting the future. Properly measured and properly labeled information about these components can then be arranged to examine and to emphasize various relationships. The appropriate de-

gree of detail is a matter of judgment and depends upon the use to be made of the information.

Revenue

Revenue is the increase in the net assets of an enterprise as a result of the production or delivery of goods and the rendering of services. "Net assets" refer to the excess of assets over liabilities; the amount of net assets is necessarily equal to the amount of owners' equity. Hence, revenues may result from increases in assets, decreases in liabilities, or some combination of the two.

46 Revenues are measured by the amount of the increase in enterprise assets or decrease in enterprise liabilities resulting from the production or delivery of goods and the rendering of services, without consideration of the related reductions in assets or increases in liabilities which may also occur. For example, when sales are made on account, the amount of revenue is usually measured by the amount of the increase in accounts receivable. Amounts included in the prices charged customers, however, which for any reason are not expected to be collected do not constitute increases in assets and hence do not result in revenues. Accordingly, sales discounts, allowances, returns, and uncollectible amounts should be deducted in the measurement of revenues.

Similarly, amounts collected or receivable from customers which do not reflect a product supplied or a service rendered do not result in revenues of that enterprise. For example, an advance of the costs of transportation provided by another enterprise or sales taxes billed to customers and payable to a governmental agency should not be included in revenues. In cases of this type the enterprise is acting merely as an agent, advancing or collecting funds for the convenience of another.

In general, then, the revenue of an enterprise during a period of time represents a measurement of the exchange value of the products (goods or services) of that enterprise during that period. This represents a measurement having considerable economic significance and one which is often useful in making interperiod and intercompany comparisons and projections.

The committee on terminology has formulated a definition, reproduced below, which is broader than the one used in this study. We make a distinction between "revenues" and "gains" (see section on "gains and losses," page 50), whereas the committee includes gains as a subdivision of revenue. Otherwise the two definitions are compatible:

Revenue results from the sale of goods and the rendering of services and is measured by the charge made to customers, clients, or tenants for goods and services furnished to them. It also includes gains from the sale or exchange of assets (other than stock in trade), interest and dividends earned on investments, and other increases in the owners' equity except those arising from capital contributions and capital adjustments.¹

Revenues should be identified with the period during which the major economic activities necessary to the creation and disposition of goods and services have been accomplished, provided objective measurements of the results of those activities are available. These two conditions, i.e., accomplishment of major economic activity and objectivity of measurement, are fulfilled at different stages of activity in different cases, sometimes as late as time of delivery of product or the performance of a service, in other cases, at an earlier point of time.²

For example, in some cases, sales, including determination of price, precede production. "Major economic activity" is then identified with production, and revenues should be recognized as production takes place. Where more than one period is required for completion, revenues should be apportioned in relation to the amount of production accomplished each period. These particular conditions are found in the case of contracts involving the construction of buildings, ships, roads, dams, etc.

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Similarly, major economic activity is complete upon the production of a commodity which has a ready market at a known price, e.g., certain minerals and certain agricultural products. The enterprise can dispose of products of this type with little or no marketing activity. For these commodities the costs of disposal are either negligible or readily predictable. Accordingly, the measurement of revenues and related costs associated with the product are objectively determinable at the time of production.

If the producing enterprise should utilize the marketable commodity in the manufacture of other products, revenues from the additional activity should be recognized in accordance with the same basic criteria. This can be illustrated by the case of a company which mines and smelts a metal having a ready market at a known price and which utilizes some of that metal in the manufacture of a product which does not have that kind of a market. Upon the production of

¹ Committee on Terminology. *Accounting Terminology Bulletin No. 2*, "Proceeds, Revenue, Income, Profit, and Earnings," p. 34.

² See Postulate C-2 on objectivity, page 7.

the marketable metal, one major activity is complete. Accordingly, any inventory of that metal should be measured by its net realizable value, (i.e., estimated selling price, less cost to complete and sell) and the revenue from the mining and smelting activity of the current period is measured by the net realizable value of the metal produced during the current period. In addition, when this metal is used in further manufacturing activity, it should be charged to production at this same net realizable value.

Revenues from services should be reflected in the period during which those services are provided. Certain services, such as the use of money and the use of facilities, are provided continuously. In cases of this type, the rates at which revenues accrue, e.g., the interest rate and the rental rate, are typically fixed in advance and revenues should accordingly be recognized on the basis of passage of time.

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Because services cannot be stored, they are generally marketed before they are created. If the marketing activity is an important and costly one, some portion of revenues is reasonably attributable to it. For example, the operations of finance companies and of leasing companies involve substantial preliminary work before receipts from customers or clients materialize. Not all of the revenues of those companies are earned during the periods of collections from customers; some of it is clearly earned by the preliminary activities. Accordingly, the revenues should be allocated to accounting periods on some systematic basis.

On the other hand, even though the major economic activities may be considered accomplished at the time of sale and delivery of product or at the time of performance of service, with a price definitely established at that time, the amount of collection costs and probability of collection may be highly uncertain. In cases of this type revenues should still be measured by the same criteria as those developed above, but special attention must be paid to an evaluation of the related receivables, and adequate allowances for uncollectibles should be made. In addition, estimates of collection costs should be made and recorded in the accounts.

Collectibility of receivables is not necessarily less predictable because collections are scheduled in installments. The postponement of recognition of revenues until they can be measured by actual cash receipt is not in accordance with the concept of an accrual accounting. Any uncertainty as to collectibility should be expressed by a separately calculated and separately disclosed estimate of uncollectibles rather than by a postponement of the recognition of revenue.

Expense

Expense is the decrease in net assets as a result of the use of economic services in the creation of revenues or of the imposition of taxes by governmental units. Expense is measured by the amount of the decrease in assets or the increase in liabilities related to the production and delivery of goods and the rendering of services, without considering the related revenues which are usually present.

The following definition and discussion of "expense" by the committee on terminology of the American Institute of Certified Public Accountants are broader than the position developed in this study because the committee includes "losses" in its definition whereas we distinguish the two. (See section on "gains and losses," page 50.) Otherwise the two definitions are compatible.

Expense in its broadest sense includes all expired costs which are deductible from revenues. In income statements, distinctions are often made between various types of expired costs by captions or titles including such terms as cost, expense, or loss, e.g., cost of goods or services sold, operating expenses, selling and administrative expenses, and loss on sale of property. These distinctions seem generally useful, and indicate that the narrower use of the term *expense* refers to such items as operating, selling or administrative expenses, interest, and taxes.³

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If the economic services emanating from a group of enterprise assets are transferred to another group of enterprise assets, there has been no expiration; from the standpoint of net assets, there has merely been a transformation in the form in which those economic services are held. Hence, the utilization of materials, labor, and facilities in the manufacture of a product is not the occasion for the recognition of expense. When the product is sold, however, its usefulness to the enterprise will indeed have expired, and the recognition of expense (usually as "cost of goods sold") is appropriate.

Expenses may be identified with a particular period of time in either of two ways:

1. They may be directly identified with particular revenue-producing transactions which have been recognized during the accounting period, e.g., the cost of the goods that are sold and delivered during that period of time, or a specified sales commission on those goods.

³ Committee on Terminology. *Accounting Terminology Bulletin No. 4*, "Cost, Expense, and Loss," p. 42.

2. They may be identified with the accounting period but cannot be directly identified with particular revenue-producing transactions, e.g., the rent of administrative offices for the year, the salaries of administrative personnel, or taxes measured by the results of operations.

“Cost of goods sold” is measured by the decrease in inventory resulting from its transfer to customers, as exemplified in the “perpetual inventory” method. As indicated earlier, in the discussion of measurement of assets,⁴ inventories should be measured by their most recently established current value (realizable or replacement).

50 In this way the sacrifice incurred in relinquishing inventory is measured in current and meaningful terms and is “matched” with revenue received from the sale, measured in the same current and meaningful terms. The advantages of measuring cost of goods sold and revenues from sales in *consistent current terms* have long been stressed as the primary justification for the use of the last-in–first-out assumption of flow of inventory costs in profit calculations. We have accepted this position in principle and extended it to the inventory items themselves.

Gains and Losses

“Gains” are increases in net assets other than (a) those resulting from investments by owners or (b) those resulting from revenues. “Losses” are decreases in net assets, other than (a) those resulting from distributions to owners or (b) those resulting from expenses.

Broadly speaking, profit arises from the supplying of goods and services. Revenues and expenses represent the components of profit, so to speak, and are centered heavily on the rendering of a service or the production of a product. Other events occur, however, which affect profit and which therefore should be taken into account. Their nature is such that they should be separately classified in the financial statements in order to increase the usefulness of the data for comparative purposes.

In the determination of earnings, the effects of changes in current costs of inventory are important and therefore should be reported. The inclusion of this information in the accounts will assist in dis-

⁴ See discussion in Chapter 4, “Inventories,” pp. 27-32.

closing the extent to which the net profit or loss is the result of changed operating margins, or of price fluctuations during the period the inventory was held. Information of this type is vital whether or not the accounts also disclose the influence of changes in the dollar (price-level changes).

The significance of changes in current costs is different from that of changes in the operating margin. Operating margins are recurring and relatively controllable; their measurement has greater predictive value. Accordingly, separate measurement of operating margins and of price gains and losses is recommended so that separate analysis and interpretation can be made.

Gains may, therefore, result from (1) the sale of assets, other than inventory, for more than book value; (2) the increase in the current value of inventories; or (3) the settlement of liabilities for less than book value (for example, bonds issued at par, reacquired at a discount).

Losses may result from (1) the sale of assets, other than inventory, for less than book value; (2) the decline in the current value of inventories; (3) the diminution or elimination of assets other than as the result of use or sale (e.g., as the result of flood, fire, or abandonment); (4) the settlement of liabilities for a consideration in excess of book value (for example, bonds issued at par, reacquired at a premium); or (5) the involuntary incurrence of liabilities; e.g., as the result of a lawsuit.

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The committee on terminology conceives of "loss" either as the antonym for "net profit" or as a subdivision of "expense," as developed in the following excerpt:

Loss is (1) the excess of all expenses, in the broad sense of that word, over revenues for a period, or (2) the excess of all or the appropriate portion of the cost of assets over related proceeds, if any, when the items are sold, abandoned, or either wholly or partially destroyed by casualty or otherwise written off. When losses such as those described in (2) above are deducted from revenues, they are expenses in the broad sense of that term.⁵

The general problem of "nonoperating gains and losses" (including the correction of errors, discussed briefly below) is analyzed in Chapter 8, "Income and Earned Surplus," of *Accounting Research Bulletin No. 43*. The conclusion reached by the committee on accounting pro-

⁵ Committee on Terminology. *Accounting Terminology Bulletin No. 4*, "Cost, Expense, and Loss," p. 42.

cedure, as expressed in paragraph 11 of that chapter, is that a presumption exists "that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income." Excluded, however, are items which meet two conditions, namely, (a) "in the aggregate are material in relation to the company's net income" and (b) "are clearly not identifiable with or do not result from the usual or typical business operations of the period." Our conclusions seem to be consonant with those of the committee on accounting procedure, at least in broad outline.

Corrections of the Measurements of Prior Periods' Earnings

In almost all formal analysis, the discussion of the measurement of earnings assumes the absence of error in the accounting. Specifically, "the amount of the owners' equity in the enterprise at the beginning of the period" is assumed to be measured properly, and similarly for current measurements. If errors have in fact occurred, their correction affects all measurements of owners' equity since the error was committed. Accordingly, corrections of errors that are material in their effect on the financial statements should not enter into the determination of earnings as a separate item for the period during which the error was discovered. A correction of a past error of this type does not constitute a revenue, an expense, a gain, or a loss of the current period.

Errors made in prior periods may, of course, affect a related item of the current period. For example, if last period's ending inventory was understated, then this period's opening inventory is likewise understated. The understatement affects the accounts of both periods. The correction for last period is made through retained earnings; the correction for this period is made as a matter of routine in the accounts of the current period.

SUMMARY

This study is an extension of *Accounting Research Study No. 1*.¹ It extends the analysis contained in "Basic Postulates" by applying it to the broad area of accounting for business enterprises. As a result, the emphasis in the postulates study on the measurement of wealth in the hands of economic entities becomes more specific in this study as an examination of the assets and liabilities, and related revenues and expenses, gains and losses, of business enterprises. The concept of profit becomes the focus of attention which leads to an examination of assets and liabilities in order to find the appropriate bases for measuring the results of operations for relatively short periods of time.

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In accordance with the emphasis in the postulates study, this study of broad principles takes the position that ideally all assets (and liabilities) should be recognized, as well as all changes that can be objectively determined. In addition to those changes which result from explicit transactions with other entities, this study recommends the recognition of price-level changes, of movements in replacement costs, and of changes from other causes, again provided that the evidence is objectively determinable.

The principles that are listed below are those recommended by the authors of this study, and have not been reviewed by the Accounting Principles Board of the American Institute of Certified Public Accountants. Before stating the principles that are recommended by the authors, certain definitions are given of key terms and concepts.

Definitions

Financial statements are those which purport to show financial position and results of operations, including supporting schedules, elabora-

¹ Maurice Moonitz, "The Basic Postulates of Accounting." 1961.

tions of special aspects of business activity, rearrangements of underlying data, and supplementary statements.

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

Cost is a forgoing, a sacrifice made to secure benefits, and is measured by an exchange price.

Depreciation accounting is the process of allocating the cost or other basis of measurement of the services rendered by items of plant and equipment to the products or periods that used those services. *Depreciation for any given period* is the cost or other basis of the services used up in that period.

Liabilities are obligations to convey assets or perform services, obligations resulting from past or current transactions and requiring settlement in the future.

54 *Owners' equity* is represented by the amount of the residual interest in the assets of an enterprise.

Invested capital is that portion of stockholders' equity which arose from the commitment of assets to the corporation or from the conversion of retained earnings and which will not be withdrawn or reduced except as permitted by law. *Retained earnings (earned surplus)* is the portion which arose from operations and has not been converted into invested capital.

Net profit (earnings, income) or *net loss* for an accounting period is the increase (decrease) in owners' equity, assuming no changes in the amount of invested capital either from price-level changes or from additional investments and no distribution to the owners. *Revenue* is the increase in net assets of an enterprise as a result of the production or delivery of goods and the rendering of services. *Expense* is the decrease in net assets as a result of the use of economic services in the creation of revenues or of the imposition of taxes by governmental units. *Gains* are increases in net assets other than those resulting from additions to invested capital or from revenues. *Losses* are decreases in net assets other than those resulting from reductions in invested capital or from expenses.

The term "distributions" refers to transfers of assets or of claims to assets to owners.

Summary of Principles

The principles summarized below are relevant primarily to formal financial statements made available to third parties as representations by the management of the business enterprise. The “basic postulates of accounting” developed in *Accounting Research Study No. 1* are integral parts of this statement of principles.

Broad principles of accounting should not be formulated mainly for the purpose of validating policies (e.g., financial management, taxation, employee compensation) established in other fields, no matter how sound or desirable those policies may be in and of themselves. Accounting draws its real strength from its neutrality as among the demands of competing special interests. Its proper functions derive from the measurement of the resources of specific entities and of changes in those resources. Its principles should be aimed at the achievement of those functions.

The principles developed in this study are as follows:

A. Profit is attributable to the whole process of business activity. Any rule or procedure, therefore, which assigns profit to a portion of the whole process should be continuously re-examined to determine the extent to which it introduces bias into the reporting of the amount of profit assigned to specific periods of time.

B. Changes in resources should be classified among the amounts attributable to

1. Changes in the dollar (price-level changes) which lead to restatements of capital but not to revenues or expenses.
2. Changes in replacement costs (above or below the effect of price-level changes) which lead to elements of gain or of loss.
3. Sale or other transfer, or recognition of net realizable value, all of which lead to revenue or gain.
4. Other causes, such as accretion or the discovery of previously unknown natural resources.

C. All assets of the enterprise, whether obtained by investments of owners or of creditors, or by other means, should be recorded in the accounts and reported in the financial statements. The existence of an asset is independent of the means by which it was acquired.

D. The problem of measuring (pricing, valuing) an asset is **the**

problem of measuring the future services, and involves at least three steps:

- a. A determination if future services do in fact exist. For example, a building is capable of providing space for manufacturing activity.
- b. An estimate of the quantity of services. For example, a building is estimated to be usable for twenty more years, or for half of its estimated total life.
- c. The choice of a method or basis or formula for pricing (valuing) the quantity of services arrived at under b, above. In general, the choice of a pricing basis is made from the following three exchange prices:

- (1) A past exchange price, e.g., acquisition cost or other initial basis. When this basis is used, profit or loss, if any, on the asset being priced will not be recognized until sale or other transfer out of the business entity.
- (2) A current exchange price, e.g., replacement cost. When this basis is used, profit or loss on the asset being priced will be recognized in two stages. The first stage will recognize part of the gain or loss in the period or periods from time of acquisition to time of usage or other disposition; the second stage will recognize the remainder of the gain or loss at the time of sale or other transfer out of the entity, measured by the difference between sale (transfer) price and replacement cost. This method is still a cost method; an asset priced on this basis is being treated as a cost factor awaiting disposition.
- (3) A future exchange price, e.g., anticipated selling price. When this basis is used, profit or loss, if any, has already been recognized in the accounts. Any asset priced on this basis is therefore being treated as though it were a receivable, in that sale or other transfer out of the business (including conversion into cash) will result in no gain or loss, except for any interest (discount) arising from the passage of time.

The proper pricing (valuation) of assets and the allocation of profit to accounting periods are dependent in large part upon estimates of the existence of future benefits, regardless of the bases used to price the assets. The need for estimates is unavoidable and cannot be eliminated by the adoption of any formula as to pricing.

1. All assets in the form of money or claims to money should be

shown at their discounted present value or the equivalent. The interest rate to be employed in the discounting process is the market (effective) rate at the date the asset was acquired.

The discounting process is not necessary in the case of short-term receivables where the force of interest is small. The carrying-value of receivables should be reduced by allowances for uncollectible elements; estimated collection costs should be recorded in the accounts.

If the claims to money are uncertain as to time or amount of receipt, they should be recorded at their current market value. If the current market value is so uncertain as to be unreliable, these assets should be shown at cost.

2. Inventories which are readily salable at known prices with readily predictable costs of disposal should be recorded at net realizable value, and the related revenue taken up at the same time. Other inventory items should be recorded at their current (replacement) cost, and the related gain or loss separately reported. Accounting for inventories on either basis will result in recording revenues, gains, or losses before they are validated by sale but they are nevertheless components of the net profit (loss) of the period in which they occur.

Acquisition costs may be used whenever they approximate current (replacement) costs, as would probably be the case when the unit prices of inventory components are reasonably stable and turnover is rapid. In all cases the basis of measurement actually employed should be "subject to verification by another competent investigator."

3. All items of plant and equipment in service, or held in stand-by status, should be recorded at cost of acquisition or construction, with appropriate modification for the effect of the changing dollar either in the primary statements or in supplementary statements. In the external reports, plant and equipment should be restated in terms of current replacement costs whenever some significant event occurs, such as a reorganization of the business entity or its merger with another entity or when it becomes a subsidiary of a parent company. Even in the absence of a significant event, the accounts could be restated at periodic intervals, perhaps every five years. The development of satisfactory indexes of construction costs and of machinery and equipment prices would assist materially in making the calculation of replacement costs feasible, practical, and objective.

4. The investment (cost or other basis) in plant and equipment should be amortized over the estimated service life. The basis for adopting a particular method of amortization for a given asset should be its ability to produce an allocation reasonably consistent with the anticipated flow of benefits from the asset.
5. All "intangibles" such as patents, copyrights, research and development, and goodwill should be recorded at cost, with appropriate modification for the effect of the changing dollar either in the primary statements or in supplementary statements. Limited term items should be amortized as expenses over their estimated lives. Unlimited term items should continue to be carried as assets, without amortization.

If the amount of the investment (cost or other basis) in plant and equipment or in the "intangibles" has been increased or decreased as the result of appraisal or the use of index-numbers, depreciation or other amortization should be based on the changed amount.

58 E. All liabilities of the enterprise should be recorded in the accounts and reported in the financial statements. Those liabilities which call for settlement in cash should be measured by the present (discounted) value of the future payments or the equivalent. The yield (market, effective) rate of interest at date of incurrence of the liability is the pertinent rate to use in the discounting process and in the amortization of "discount" and "premium." "Discount" and "premium" are technical devices for relating the issue price to the principal amount and should therefore be closely associated with principal amount in financial statements.

F. Those liabilities which call for settlement in goods or services (other than cash) should be measured by their agreed selling price. Profit accrues in these cases as the stipulated services are performed or the goods produced or delivered.

G. In a corporation, stockholders' equity should be classified into invested capital and retained earnings (earned surplus). Invested capital should, in turn, be classified according to source, that is, according to the underlying nature of the transactions giving rise to invested capital.

Retained earnings should include the cumulative amount of net profits and net losses, less dividend declarations, and less amounts transferred to invested capital.

In an unincorporated business, the same plan may be followed, but the acceptable alternative is more widely followed of reporting the total interest of each owner or group of owners at the balance sheet date.

H. A statement of the results of operations should reveal the components of profit in sufficient detail to permit comparisons and interpretations to be made. To this end, the data should be classified at least into revenues, expenses, gains, and losses.

1. In general, the revenue of an enterprise during an accounting period represents a measurement of the exchange value of the products (goods and services) of that enterprise during that period. The preceding discussion, under D(2), is also pertinent here.
2. Broadly speaking, expenses measure the costs of the amount of revenue recognized. They may be directly associated with revenue-producing transactions themselves (e.g., so-called "product costs") or with the accounting period in which the revenues appear (e.g., so-called "period costs").
3. Gains include such items as the results of holding inventories through a price rise, the sale of assets (other than stock-in-trade) at more than book value, and the settlement of liabilities at less than book value. Losses include items such as the results of holding inventories through a price decline, the sale of assets (other than stock-in-trade) at less than book value or their retirement, the settlement of liabilities at more than book value, and the imposition of liabilities through a lawsuit.

Comments of Andrew Barr

This "Tentative Set of Broad Accounting Principles for Business Enterprises" must be recognized as a statement of what the authors believe generally accepted accounting principles should be rather than what they are today. As stated, they include significant departures from present practice and hence require critical examination and testing. In some respects, the proposals might be tested during a conversion period by means of supplementary statements. However, indiscriminate application of the principles could result in false and misleading financial statements and might tend to undermine the confidence of the public in all published financial statements.

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Comments of Carman G. Blough

This "Tentative Set of Broad Accounting Principles for Business Enterprises" is a notable contribution to the literature of our profession and a commendable presentation of the views of its authors as to what accounting principles ought to be. As a research study of accounting principles designed to be a guide in the solution of the numerous day to day problems of the profession, however, it leaves much to be desired.

Accounting principles are not theoretical hypotheses untried in practice or tried and discarded as impractical. Accounting has been evolutionary, just as have the principles of the other arts, law and medicine, for example. Experience teaches us many things as to what will work and what will not. Some of the so-called "principles" set forth in this document have never been even experimented with, to say nothing of having been proved practical. Others have been experimented with in a very, very few cases, the results of which have been far from convincing as to their practicality or their general acceptability. Still others have been tried and found so lacking in objectivity

as to lend themselves to misrepresentation and distortion. An example of each may help to clarify these points.

1. The idea of recognizing profit on the sale of an asset in two stages is certainly one that has never been tried. The revaluation of raw materials, goods in process and finished goods at "current exchange-price" with a resulting recognition of any increase as profit, would not be too difficult, though onerous enough, if it were to be done only with respect to inventories on hand at the close of a fiscal period, but to attempt it on a continuous basis strikes me as being highly impractical. Certain types of perpetual inventory records may possibly lend themselves to such adjustments without undue effort and expense, but what of the innumerable situations in which adherence to such a principle would be tremendously burdensome, if not impossible?

The argument is made that this is consistent with our present method of valuing inventories at the lower of cost or market. It should be noted, however, that the cost or market rule, which is now generally followed, relates only to the inventories on hand at the balance-sheet date. Furthermore, the convention of anticipating losses but not profits is one of the oldest principles of accounting. It has evolved from, and has been proven desirable by, the experiences of businessmen for generations. Consistency has its place, and in some accounting matters it is of paramount importance, but there are limitations both to its usefulness and to its applicability. Experience has demonstrated that it is sound business policy to wait until profits are realized before they are reported while providing for losses as soon as they are apparent. Too many businesses have gone into bankruptcy for not observing such a principle to warrant brushing it aside merely because it seems not to be internally consistent.

It seems to me that until the practicability of the proposed method has been tested under varying conditions and more convincing arguments are made as to the usefulness of the information so obtained, it would be unwise to consider it a principle.

2. Adjustments of financial statements to give effect to the results of price-level changes have been experimented with in several studies referred to in this document. However, even with the encouragement given to furnish supplementary information as to the effect of such changes on financial statements which was contained in the *Accounting Research Bulletins* of the AICPA's committee on accounting procedure and in the statements of the American Accounting Association's Committee on Concepts and Standards, the number of companies that have

evidenced any interest in following the proposal could be counted on the fingers of one hand.

Although the Accounting Principles Board has agreed that "the assumption in accounting, that fluctuations in the value of the dollar may be ignored, is unrealistic," and has requested the accounting research staff to study the matter, it cannot be said that the Board has reached the conclusion that the financial statements should be adjusted to give effect to changes in the price level. Indeed, in stating its wishes to the staff it specifically requested that recommendations be made for the disclosure of the effect of price-level changes on the financial statements with special attention to the use of supplementary statements as a means of disclosure. While the Board may decide that there should be adjustments to the financial statements themselves, this is a long way from being a foregone conclusion. In the circumstances, it can hardly be demonstrated that there is presently any authority for stating that the adjustment of accounts for price-level changes is an accounting principle.

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3. The idea that "plant and equipment should be restated in terms of current replacement costs" whenever some significant event occurs, otherwise at "periodic intervals, perhaps every five years," is an old and discarded idea with only a slightly new twist. Shades of the 1920's! Those of us who remember how impossible it was to determine the fairness or reasonableness of the results of an appraisal shudder at the idea of going through it all over again. The mere fact, if it be a fact, that under current methods calculation of replacement costs are "feasible, practical, and objective" does not validate replacement cost as a meaningful figure. The reasons why replacement cost lacks significance, by itself, as a measure of current value have been dealt with so often by so many that there would be no merit in repeating them here.

There is plenty of room for improvement in the field of accounting principles and much need to narrow or eliminate areas of differences that now exist, but it would seem that a logical and cohesive statement of basic principles selected from the many which have been found workable and useful would be a logical beginning.

This is not to say that we must look only to the past. Technical developments may afford an opportunity for accepting accounting principles that would have been out of the question heretofore. Accounting must constantly evolve to meet changing conditions, to use improved methods and to give effect to constructive forward thinking.

However, before we discard the principles that have served us long

and well in preference to new and untried ones, it would seem essential to show that a more cohesive and logical body of principles would result, that financial reports would be more meaningful and useful and that it would be practical to put the new ones into effect. This, it seems to me, has not been done in the study before us.

Comments of Arthur M. Cannon

This tentative statement of accounting principles is an excellent job. It is courageous but not revolutionary in the things that it says that need to be said and the improvements that are proposed. These improvements will go far in the direction of truly reflecting "financial condition and results of operations" in the statements that purport to make such representations.

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I am particularly pleased with the proposal to price inventories at current values, realizable value when readily available and otherwise replacement cost. I would go further in the same direction in the areas of fixed assets, though I recognize the distinction between current assets as those held for relatively prompt liquidation and fixed assets as those held for productive use over a long period. Since I am familiar with real estate, I would not find it difficult to accept a current value principle for valuation of land and buildings based on expert and independent appraisal reviewed by the accountant. That kind of evidence is just as good and, in some cases, better than evidence we are using already in other areas. I am sure that persons familiar with machinery and equipment would find it equally easy to accept the notion of re-appraisal thereof to current value from time to time.

In setting out current values on the balance sheet and thus causing it to become a more adequate and useful approximation of financial condition, it is important to recognize that, in the related statement of income, we will be recognizing explicitly more different kinds of changes in stockholders equity than we have heretofore. In addition to results of ordinary operations, the income and surplus statement will show the effect of revaluing for price-level changes, the effect of revaluing for changes in prices of specific articles or commodities, and other

gains or losses. What are referred to as gains or losses from "holding" assets means changes in prices of particular items apart from over-all changes in the general price level. Like all averages, the changes in general price level conceal at least as much as they reveal. There is a tremendous variety and range of individual changes within that average—some above and some below, some very widely divergent, and some going one direction while the average goes the other, etc. These individual changes probably mean more than the over-all price-level change in evaluating the financial condition of a particular business.

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Let me use an illustration. The other day we made a mortgage loan for the construction of a new shopping center in San Jose, California, a very fast growing area. The land in question was the sole asset of the owner, and he had purchased it as a farm for \$8,000 about fifteen years ago. It was currently appraised at \$300,000, and we made a mortgage loan of \$350,000 for the new construction, the total value when completed to be \$650,000. The over-all price level in the period the farmer held the land approximately doubled. If we accountants prepared a statement for this farmer just before the indicated transaction, we would show the asset at \$8,000 and net worth at \$8,000 (other items excluded). If we took the price-level change into account, we would show the asset at \$16,000 and the net worth at the same amount. The change in the price level is trivial in comparison with the over-all change in value. After the construction and the loan are completed, a traditional accountant's statement would show the land and buildings at \$358,000, the loan at \$350,000 and the net worth at \$8,000, and, if the price-level change were recognized, then the asset would be \$366,000, the loan \$350,000, and the net worth \$16,000. This statement of financial condition is a long way from financial condition, whether based on cost or whether based on cost adjusted for the price-level change. What is needed, of course, is to show the land at its current value, \$300,000—in which case the total asset will be \$650,000, the loan \$350,000 and the net worth \$300,000. In that net worth should be reflected cost \$8,000, adjustment by reason of price-level change, another \$8,000, and appreciation by reason of holding in a rising market, \$284,000.

The most helpful statements of financial condition that I see among those that come across my desk every day now tend to include a two-column balance sheet with the assets valued in one column at cost and in the other at current value, with the liabilities the same in both columns, and with the net worth at cost in both columns but with appre-

ciation reflected in the current value column. I have seen no effort to break down that appreciation between the specific and the general price change. I think it desirable to show that breakdown between the specific and the general, but the overriding requirement is to bring the total and actual current value onto the statement. I have seen borrowers or potential borrowers badly hurt by the use of traditional accounting statements in which assets are held to cost, liabilities reflect loans made against current market values, and net worth may show a trivial amount or even a substantial deficit, entirely contrary to the facts of the situation.

I should like to comment also on the comments of Messrs. Paul Grady and Leonard Spacek reproduced herein. I have the highest regard for both of them and for their opinions. However, Mr. Grady's statement is essentially a defense of the status quo and that is not the task of the Accounting Principles Board. The charter rules of the Board are perfectly definite as follows:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and should, take definite steps to lead in the thinking on unsettled and controversial issues.

As to Mr. Spacek's statement, he says the published accounting postulates and these accounting principles are a set of unsupported opinions, but no fair-minded reader of either of these monographs, each of considerable length, could join in that opinion. On the contrary, it is Mr. Spacek who states a personal opinion unsupported by argument and expects to carry it by the very vehemence of his assault. He is welcome to his opinion and it will have weight with many as it does with me, but he is wrong to say that these monographs are no more than personal opinions.

The present monograph on principles goes well now with the previous monograph on postulates and the significance of the latter becomes much more apparent. I think, perhaps, the postulates monograph might now be rewritten somewhat and condensed somewhat to make the transition to the principles a little more ready and obvious.

We are squarely on the track of the special research committee's

plan and the charter rules of the Board. It will be easier to develop rules for specific situations with these principles before us. The thinking and exposition that went into the postulates provided a good base for the principles. Most important, we are about to make the great stride from cost-based to current-valued assets and net worth in financial statements.

Comments of Oscar S. Gellein

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Mr. Gellein believes that publication of the research study will serve no useful purpose and likely will delay development of the broad principles comprehended in generally accepted accounting principles. He further believes that orderly development of accounting principles requires completion of two phases of research or study before a public judgment is sought concerning acceptability of the principles.

The two steps, one as important as the other, are (a) formulation of a theory by processes of logic and (b) tests of the theory for practicality and reasonableness. Logic can produce many theories of accounting as it has produced varying theories in other fields. Operative accounting principles derive from the theory that satisfies tests of usefulness in the varying circumstances of accounting.

The research study, for example, places conservatism and realization in less important positions than they have conventionally occupied, and redefines standards of objectivity. Significant recasting of long-standing accounting principles calls for proof by way of both analysis and tests that the new is more useful than the old. Mr. Gellein believes that the research study does not furnish this proof.

Comments of Paul Grady

In the summer of 1961, Paul Grady, as a member of the project advisory committee on broad accounting principles, submitted some detailed criticisms of an earlier draft of this study. He later prepared the more extended statement that follows. With the addition of three introductory paragraphs (omitted in the material that follows) it will appear as an article in the May 1962 issue of *The Journal of Accountancy*, the same issue in which the summary chapter of this research study will appear. This statement sets forth his comments on the approach taken in these research studies as well as his suggested summary of what a statement of generally accepted accounting principles should contain.

As a member of the project advisory committee on broad accounting principles, Mr. Grady is entitled to have his comments included in this research study. I have chosen to publish this relatively long statement in lieu of a shorter one in order to assist the reader in focusing more sharply on the issues involved.

MAURICE MOONITZ, *Director of Accounting Research*

Some fifteen years ago, the committee on auditing procedure, of which I was chairman (1944-48), was engaged in the study of the meaning of "generally accepted auditing standards." As is the case with "generally accepted accounting principles," the term "generally accepted" had been used in the standard form reports of certified public accountants for several years without any explicit definition. Undoubtedly, the task of dealing with accounting principles is more difficult than the task we had with auditing standards. It is suggested, however, that there may be points of similarity which are worthy of consideration by members of the Accounting Principles Board.

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Take All the Time That Is Needed

The first point is the matter of time required for completion of the task. It required three years for the committee on auditing procedure to produce the tentative statement on "Generally Accepted Auditing Standards—Their Meaning and Significance." A fourth year was required for discussion in the profession before the summary of standards was approved by the members of the Institute. It is reasonable to expect the accounting principles project to take a longer period of time, both due to the nature of the problem and to the use of the accounting research studies as forerunners of decisions by the Accounting Principles Board. Accordingly, it is recommended that the Board

ignore any pressures that may develop toward speeding up the program. This is not a crisis problem and time to be gained is not worth the risk of sacrificing quality in the decisions to be reached.

Nature of the Quest

A research study, the purpose of which is discovery of new lines of reasoning and new demonstrable facts, will necessarily be of a different character than one whose purpose is to analyze existing facts and to organize the lines of reasoning into a more understandable and more useful pattern. The committee on auditing procedure had no difficulty reaching an early conclusion that our study of generally accepted auditing standards was not a discovery mission.

In introducing the three major papers on auditing standards at the 1947 annual meeting of the Institute, the chairman of the committee made the following comment:

Toward the end of his career Sir Isaac Newton said he felt like a small boy at the seashore who had discovered a few shells but had before him the vast unexplored ocean. The only common point between this remark and the committee on auditing procedure is that we are now at the seashore [Atlantic City]. The work of the committee has not been a discovery mission, because the auditing standards with which we are dealing have been inherent in the accounting profession from the beginning. Our endeavor has been more in the nature of a screening process to separate the "shells" of standards from the "sands" of procedures and to arrange the standards in a useful pattern.

It may be well to recall the utter simplicity of the general or personal standards — proficiency, independence and due care. The seven further standards grouped under field work and reporting are to a large degree cross-sectional classifications for the purpose of illustrating more clearly the application of the basic standards. Proficiency and independence, in a sense, are prerequisites to professional auditing work, and accordingly due care may be regarded as the active pervading theme in generally accepted auditing standards.

The term "generally accepted accounting principles" first came into use in the reports of certified public accountants as the result of the correspondence, published in 1934, between an Institute committee, a committee of the Controllers Institute, and the New York Stock Exchange. It was generally recognized that there were areas in which alternative accounting practices were prevalent. This was one of the reasons for the suggestion in the correspondence that a statement of

the corporation's major accounting policies be approved by directors and made available to stockholders. The term "generally accepted" contained an element of restriction since it required, obviously, a broader band of acceptance than merely the practice of one corporation, and the judgment of what was generally accepted was left to the certified public accountant.

The identification and description of generally accepted accounting principles necessarily embraces more than the professional work of certified public accountants and must reach back to the primary steps by which management meets its accountabilities to investors and others having legitimate interests in the business enterprise. While this makes the quest more difficult, it does not convert it into a discovery mission. The problem is largely one of identification of the principles, on which there is general agreement, and of developing a useful pattern of arrangement or classification. It seems clear that the Institute has the responsibility of establishing an inventory of current generally accepted accounting principles before, or at least separate from, undertaking substantial changes.

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A Blending of Logic and Common Sense

In a brief discussion of the method to be followed in the studies of postulates and principles, the Director of Accounting Research said:¹

We are driven to the conclusion, then, that relatively heavy reliance must be placed on deductive reasoning in the development of accounting postulates and principles. We must first recognize and define the problems to be solved, then move to their solution by careful attention to what "ought" to be the case, not what "is" the case. Hopefully, the two, "ought" and "is," will not be too far apart but we have no reason to expect them to be identical.

This attitude seems to place a greater burden on theory and logic than has been expected in the past even by those who have specialized in theory. In 1939 Professor A. C. Littleton said:²

Accounting theory, since it has grown largely out of accounting practice, may seem to serve principally as a means of explaining

¹ Maurice Moonitz, "The Basic Postulates of Accounting," *Accounting Research Study No. 1*, American Institute of Certified Public Accountants. 1961, p. 6.

² A. C. Littleton, *Essays on Accountancy*, University of Illinois Press. 1961, p. 376.

and illuminating what is done in accounting. But theory has a further obligation, that of strengthening practice by subjecting customs to analysis and testing their justification by finding the relation of customary ideas to basic concepts and purposes.

Nine years later (1948) the same educator in discussing the application of theory to a problem said:³

Perhaps theory can help, if we do not expect too much. Theory, you will agree, can be an aid to understanding and understanding united with practical wisdom can carry us a long way toward a good choice. Perhaps it is too much to expect either theory or practice to be completely satisfactory alone. I am convinced that theory could not [be of help in the particular situation], for theory does not direct; when we use theory we do not seek to prescribe. We are only trying to analyze, to understand, to persuade. Theory therefore must consist of explanations, definitions, reasons, justifications, persuasions. And only sometimes of suppositions and hypotheses.

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Accountancy is a very practical art and has been called the "language of business" to briefly indicate its important intelligence and communication function. The Accounting Principles Board's most difficult task may well be to see that the logic and theory of the research studies are given a proper blending with common sense and business judgment in the Board's own conclusions. In this connection these words of Justice Holmes seem quite appropriate:⁴

. . . the whole outline of the law, as it stands today, is the resultant of a conflict between logic and good sense—the one striving to carry fictions out to consistent results, the other restraining and at last overcoming that effort when the results become too manifestly unjust.

. . . the logical method and form flatter that longing for certainty and for repose which is in every human mind. But certainty is illusion, and repose is not the destiny of man.

It seems to me there would be great merit in having a brief summary of generally accepted accounting principles for business enterprise as of the present time. Theoretical explanations, reasons, justifications and logical criticisms should be presented in such volume as may seem appropriate but the summary should stand out for its own practical uses. For whatever it may be worth, such a suggested summary is submitted in the following pages.

³ *Ibid.*, p. 310.

⁴ Oliver Wendell Holmes, *Collected Legal Papers*, Harcourt, Brace & Co. 1920, pp. 101 and 181.

Principles of Financial Accounting for Business Corporations

Accounting serves many purposes in the broad fabric of incorporated business enterprises. The most important is to supply the comprehensive and dependable information required in order that management may fulfill its fiduciary accountabilities to stockholders, creditors, government and others having bona fide interests. The principles of financial accounting for corporate business enterprise logically and usefully may be classified in relation to these fiduciary accountabilities. Such principles are necessarily stated in broad terms of objectives and major criteria and the complexities facing modern business make more definitive rules necessary to implement the principles in relation to the pertinent circumstances of the time. In a changing world it naturally follows that detailed rules not only may but should be changed to meet changes in conditions or in the mode of thought of the business community and that such changes do not necessarily affect the broader principles and postulates all of which are comprehended in the term generally accepted accounting principles. In this context, the principles of financial accounting for corporate business enterprise are summarized as follows:

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A. Account for sales, revenues, income, cost of sales, expenses, gains and losses in such manner as to fairly present the results of operations for the period or periods of time covered.

1. Sales, revenues and income should not be anticipated. Accordingly, there must be proper cutoff accounting at the beginning and end of the period or periods.
2. Costs of sales and expenses should be appropriately matched against the periodic sales and revenues. It follows that there must be proper cutoff accounting for inventories and liabilities for costs and expenses at the beginning and end of the period or periods.
3. Appropriate charges should be made for depreciation and depletion of fixed assets and for amortization of other deferred costs.
4. Proper distribution of costs should be made as between fixed assets, inventories, maintenance and expense. Direct costs are usually identifiable and common costs applicable to more than one activity should be distributed on appropriate cost incurrence bases such as time or use factors.
5. Nonrecurring and extraordinary gains and losses should be shown separately from the ordinary and usual operations.
6. There is a strong presumption that all gains and losses will be in-

cluded in periodic income statements unless they are of such magnitude in relation to revenues and expenses from regular operations as to cause the statements to be misleading.

7. If accounting principles in the determination of periodic results have not been consistently maintained, the effect of the change should be stated.

B. Account for the equity capital invested by stockholders through contribution of assets or retained earnings in a meaningful manner on a cumulative basis and as to changes during the period or periods covered.

1. In case there are two or more classes of stock, account for the equity capital invested by each and disclose the rights and preferences to dividends and to principal in liquidation.
2. From a financial viewpoint the capital invested by stockholders is the corpus of the enterprise and its identity should be fully maintained. Any inroads in capital resulting from operating deficits, losses of any nature, or dividend distributions in excess of earnings, should be accounted for both currently and on a cumulative basis.
3. In case of substantial monetary inflation appropriate conversion adjustments should be undertaken in order that the capital of the enterprise may be maintained in terms of the purchasing power invested by the stockholders.
4. All charges and credits to retained earnings and to any paid-in or other capital surplus accounts should be disclosed for the period or periods covered.
5. There should be no commingling of retained earnings with capital surplus items. Retained earnings should represent the cumulative balance of periodic earnings less dividend distributions in cash or stock, plus or minus gains and losses of such magnitude as not to be properly included in periodic earnings. Retained earnings may also be decreased by transfers to capital stock accounts through appropriate formal corporate action. Accumulated deficit accounts may not be eliminated against capital accounts or capital surplus except by appropriate formal corporate action approved by stockholders which establishes a new base line of accountability.

C. Account for the assets invested in the enterprise by stockholders (through property contributed or retained earnings) or by creditors in a meaningful manner so that when considered with the liabilities and equity capital of stockholders there will be a fair presentation of

the financial position of the enterprise both at the beginning and end of period. It should be understood that financial position or balance sheet statements do not purport to show either present values of assets to the enterprise or values which might be realized in liquidation.

1. Items classified as current assets should be carried at not more than is reasonably expected to be realized in the normal course of the business operations. Cash should be segregated between unrestricted and restricted items and the inclusion of the latter in current assets must be justified by their nature. Receivables should be reduced by allowance accounts to cover expected collection or other losses. Receivables from officers or affiliated companies should be shown separately. Inventories should be carried at direct costs plus factory overhead costs and the basis of determination (i.e., Lifo, Fifo or average) should be stated. Prepaid items should be properly chargeable to future periods.
2. Fixed assets should be carried at cost of acquisition or construction, adjusted or converted when necessary to reflect substantial changes in the purchasing power of the monetary unit. Cost of land should ordinarily be shown separately. Cost of construction includes direct costs and overhead costs incurred, such as engineering, supervision and administration, interest and taxes. Items treated as fixed assets should have at least one year of expected useful life to the enterprise and normally the life is considerably longer. Practicable yardsticks or criteria should be established in order that consistent distinctions may be made between fixed assets, operating expenses and maintenance. Ordinarily, this should be accomplished by creating a catalogue of property units to be included in fixed assets, any lesser items to be charged to current expense.
3. Appropriate provision or allowances should be made in order to charge operations with the investment in depreciable assets over the estimated life thereof. The accumulated allowances, less property retirements, should be shown as a deduction from fixed assets.
4. Long-term investments in securities ordinarily should be carried at cost. Where market quotations are available the aggregate quoted amounts should be disclosed. Investments in affiliates should be segregated from other investments.
5. The costs of intangible items, such as debt discount and expense, patents, copyrights, research and development (if deferred) and goodwill should be shown separately. Limited term items should

be amortized against earnings over their estimated lives. The policy in regard to amortization of unlimited term intangibles should be disclosed.

6. The nature and extent of hypothecated or pledged assets should be shown.

D. Account for all known liabilities in a meaningful manner in order that their summarization, considered together with the statement of assets and equity invested by stockholders, will fairly present the financial position of the enterprise at the beginning and end of the period.

1. All known liabilities should be recorded regardless of whether the definite amount is determinable. If the amounts cannot be reasonably approximated, the nature of the items should be disclosed in the face of the summary of liabilities or by footnote.
2. Current liabilities should include items payable within one year from the end of the period or the end of the operating business cycle used in the classification of current assets. Accounts should be shown separately for notes payable to bankers, notes payable to others, accounts payable (may include payrolls), Federal income taxes accrued, other accrued taxes, accounts or notes payable to officers and accounts or notes payable to affiliates.
3. Long-term liabilities should be described and due dates and rates of interest shown.
4. The nature and extent to which specific liabilities are a preferred lien on assets should be shown.

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Probably the only unexpected item in the foregoing summary is the requirement for price-level adjustments when there are substantial fluctuations in the purchasing power of the monetary unit. Some months ago the Accounting Principles Board agreed that the assumption in accounting that fluctuations in the value of the dollar may be ignored is unrealistic. This seems clear-cut approval of the principle of price-level adjustments. It is recognized, of course, that the study project is not completed and that it will have to deal with such matters as criteria for determining what are substantial fluctuations, for the selection of indices for measurement of purchasing power variations and whether to use supplemental statements.

In my view, recognition of the necessity for price-level adjustments is the greatest forward step ever taken in accounting. It closes the gap of disharmony which has existed between inventory and fixed asset accounting since the introduction and approval of Lifo method.

Of even greater importance, it affords a sturdy foundation for the following basic concepts and objectives for financial accounting:

1. The purchasing power of equity capital invested in an enterprise, either by assets contributed by stockholders or by retained earnings, must be maintained in statements of financial position.
2. Periodic business income is to be determined by the matching of revenues and related costs and expenses—all stated in homogeneous current monetary units.

It will be noted that the pervading theme of the summary is the fiduciary accountability of management to investors in the business enterprise. This term is not used in any legalistic sense but rather in the broader concept of responsibilities which most managements of business enterprise in America have shown toward investors and others having legitimate interests. The structure of the summary is related to the types of financial statements now considered essential, but there is ample flexibility to introduce other forms when and if they become essential. It is believed, also, that more detailed rules of accounting, such as the ARB's previously issued, or similar rules to be issued by the Accounting Principles Board in the future, may be related meaningfully to the salient points in the summary.

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Accounting Progress a Continuous Process

Previously, reference has been made to the time required for the completion of the basic projects on accounting postulates and principles and, of course, time will also be required for the several special topics on which research projects have been undertaken. There seems to be a tendency by some members of the profession to equate this pause in the technical legislative process of the Institute with a stoppage in accounting progress. Such an attitude is a serious error.

From the beginning, progress in accounting has been evolutionary rather than revolutionary. The greatest force for progress has been the persuasive efforts of individual certified public accountants in urging the adoption of the better of alternative practices by their clients. Every client is entitled to the best judgment and advice of the accountant, who must not be stopped by the first line of resistance even though the client's practice is not so bad as to require qualification. Often it will be found that the objections stated by lower levels of management are not shared by the upper levels. If it is objectively, competently and courageously applied, the scrub brush of good accrual accounting holds the solution to most of the dingy areas of accounting practice.

Comments of Herbert E. Miller

It is apparent that the tentative set of broad accounting principles is not an attempt merely to enumerate prevailing practices or to list those areas in which there is majority support. The tentative set is constructive and challenging, but, if the recommendations made therein are adopted, I believe that the accounting process will, on balance, become more subjective. This is attributable to the greater reliance placed on such information as net realizable values, market values, current replacement costs, and appraisal data. Although the authors have been careful to point out the importance of using objective information in support of the valuation methods advocated, much will depend on whether reasonably uniform tests are developed and applied in connection with the use of the "new" information and whether the "new" valuation bases become widely enough adopted to give published financial statements some appearance of conformity. I am not suggesting that greater subjectivity as such will be bad for accounting, but it is a matter worthy of serious consideration.

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In my opinion, there is a related but perhaps more significant worry that could arise with the publication of this study. This is traceable to the fact that important changes are recommended without submitting any guide lines indicating to the profession how it might move from the position it now supports (admittedly not a place susceptible of precise description) to the position advocated by Drs. Sprouse and Moonitz. In view of the proposed further relaxation of the realization rule and the modification of our cost concepts (permitting "cost or higher" as well as cost or lower), I am fearful of abuses and a lessening of confidence in published financial statements. Such prospects might be avoided if some way could be found to assure widespread and quick adoption of the broad principles set forth in the research study. Ideally, the matter of implementation should have been studied concurrently. It seems to me that the absence of any plans or suggestions for transition and adoption not only increases the risk of abuse and uncertainty, but detracts from the chances for the research effort to receive the consideration it deserves.

Comments of Leonard Spacek

The principal purpose of the two research studies on accounting postulates and principles by the Accounting Research Division of the American Institute of Certified Public Accountants is to establish a sound foundation for and a general framework of accounting theory so that financial accounting and the resulting financial reporting will meet the current needs of all segments of our society. If this is to be achieved, a necessary prerequisite is an accurate and clear statement of the purposes and objectives of accounting. From such a starting point, the foundation and the structure must be built step by step, each supported by comprehensive and logical reasoning relating it to the purposes and objectives, and each strengthening the others in a co-ordinated manner.

As indicated in my comments on the research study relating to "The Basic Postulates of Accounting" (*Accounting Research Study No. 1*, page 56), I do not consider that the propositions there advanced as constituting the basic postulates afford an adequate foundation or basis for the formulation of accounting principles. This research study on the broad accounting principles further reveals the complete lack of such a foundation in either study. The accounting principles presented are neither adequately supported nor successfully defended; this becomes evident when, with respect to each, the simple question is asked—why?

The introduction to this study states: "The principles of financial accounting that are developed in this study are designed to meet the needs of all interested groups." (Reference in this regard is made to management, owners, creditors, government, and others with bona fide interests.) This objective is excellent, but the subsequent discussion leading up to the statement of principles represents a series of personal opinions that are not supported in any significant manner as to *how* or *why* the so-called principles "meet the needs of all interested groups," or as to *why* the conclusions represent a sound and co-ordinated framework of accounting theory. Furthermore, there is very little attempt to demonstrate how these principles flow from or are based on the postulates set forth in the previous study. This is understandable, of course, since the self-evident observations or propositions advanced as basic postulates in that study cannot provide a suitable foundation for the formulation of accounting principles, nor do those postulates afford an objective guide against which to test the principles proposed.

While my criticism relates more to what is not said than to what is said, there are a number of statements in this study with which I do not agree. But, no purpose would be served by commenting thereon in any detail. At this stage of the research program, it is more important to discuss the bases for the conclusions presented; otherwise, only unsupported personal opinions based on obscure premises would be in controversy.

True research involves a critical and objective analysis in considerable depth of the logic and the reasoning underlying the conclusions reached. The reasoning set forth in this study is, in my opinion, inadequate, incomplete, superficial and lacking in logical support.

As an example of what I have in mind, the principles developed include the statements that: (1) inventories that can be sold merely by making delivery should be recorded at net realizable value and other inventory items should be recorded at their current (replacement) cost; (2) plant and equipment and "intangibles" should be recorded at cost with appropriate modification for price-level changes (it is stated that such modification may be done in supplementary statements, in which event the recorded costs in the accounts would not be adjusted); and (3) the investment in plant and equipment and "limited-term intangibles" should be amortized over their estimated lives and "unlimited-term intangibles" should be carried as assets without amortization. The study does not give adequate reasons as to *why* these principles are logical and defensible in relation to each other and *why* they "meet the needs of all interested groups," i.e., produce fair results for all segments of the business community (management, labor, stockholders, creditors, customers and the public).

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These first two research studies must be considered together. They do not set forth the basic postulates and principles that should underlie the accounting for and presentation of financial position and results of operations in a broad sense. This over-all viewpoint is discussed in a general way in Chapter 2, with no reasoning or conclusions of any consequence, and is referred to somewhat indirectly in subsequent chapters and in the statement of principles. However, a discussion of assets, liabilities, revenue and costs is premature and meaningless until the basic principles that will result in a *fair* presentation of the facts in the form of financial accounting and financial reporting are determined. This fairness of accounting and reporting must be for and to people, and these people represent the various segments of our society.

Research projects are in process for such complicated accounting

problems as those related to accounting for income taxes, business combinations (poolings of interests), intercorporate investments, pensions, price-level changes, and a number of others. The broad accounting principles as set forth in this study do not offer well supported standards and guides for the solution of these problems. Without such standards and guides, those who are conducting these other research studies will be giving their own opinions without any clear-cut support from the basic structure of accounting theory.

Accounting research, if it is to be worthy of that name, must accomplish what has been done in many other fields of knowledge — determine exactly what is needed in the public interest and then establish those principles which meet that need on a sound and logical basis. In my opinion, these two studies on the postulates and principles have not done this; and, until this is done, the results of further research studies involving accounting practices in various areas cannot be persuasive or effectual.

Comments of William W. Werntz

(NOTE: *These comments were received in the form of a letter to the Director of Accounting Research.*)

I have finally had the opportunity to read with some care the February 1962 draft of "A Tentative Set of Broad Accounting Principles for Business Enterprises" which you and Dr. Sprouse have prepared. The care and thoughtfulness with which you have approached this task is self-evident.

I regret to have to say that I think it would be a disservice for this study to be published in its present form. I am in agreement with you that it was not your task merely to seek to describe existing practices. On the other hand, I am extremely fearful that, in the way in which the document has been prepared, there is an inadequate distinction between practices which have received general acceptance to date and those which you propose as additions to or changes in existing practices. It is evident that effort has been made to make this dis-

inction, but I do not think the result goes far enough. In the hands of some, I fear the study would be used indiscriminately as authority for financial presentations that under present circumstances would be misleading.

Even granting for the moment the desirability and acceptability of all of the substantive proposals, I feel the document should not be published unless it contains ground rules for a transition to the new basis. Lacking such discussion, it should, as a minimum, state quite clearly at the outset that certain of the proposals which are made are presently not in accordance with generally accepted accounting principles. I would go further and suggest that at an early point in the document there be a separate summary statement of those proposals which you regard as departures from generally accepted accounting principles so there could be no possible misunderstanding on this score.

80 I am also unhappy at the imbalance of the treatment as between varying sectors of accounting principles. For example, there is an exhaustive discussion of the use of the interest factor in discounting liabilities and the treatment to be accorded such discount. On the other hand, the whole problem of intangible assets is dismissed, as I see it, in a single paragraph, and then largely by reference to the discussion of plant and equipment. Similarly, so far as I can determine, no mention is made of the problem of tax allocation. I realize this is under separate study, but your study purports to cover broad accounting principles, and some mention of this with a reference to the study, as is done in other cases, should be made. There are a number of other similar situations.

The treatment of the problem of realization is unsatisfactory in my opinion. To begin with, the discussion leaves the definite impression that sale as the point of realization is a minority practice, or, perhaps, that it should be. To the best of my knowledge, precisely the contrary is true. There are, of course, a number of well defined types of business in which another basis is utilized but these, with the possible exception of long-term contracts, are relatively infrequent. Note in this connection the use of the word "sometimes" at page 47 which clearly seems to imply that "sale" is only occasionally the point at which to recognize revenues.

My second objection is to the concept of recognizing profit for income purposes (a) where replacement cost is higher than acquisition cost, and (b) where an intermediate product has a ready market, as in the case of some metals. You, of course, are quite correct that replacement cost is utilized to write down inventories at the present

time. It is true also that there are methods of determining or calculating replacement cost as a basis for comparing it with acquisition cost. In such present usage, however, it is merely a method of estimating a probable inability to recover acquisition cost. It is not a method of introducing new values into the balance sheet.

I have exactly the same feelings with respect to the use of appraisals of real property. When used to allocate cost as between items of property or to write down property, I see no objection, as the appraisal is again only a method of estimating a loss. Where appraisals result in a net write-up, I have seen only a few cases in which I would want to introduce such values into the balance sheet and the present or future determination of earnings. Certainly I would not think of this as a once-every-five-years concept.

It is my opinion that realistic market prices are not nearly so widespread as would be necessary if your theory were to be adopted. Possibly the clearest case is that of the stock market quotations themselves. While these quotations are probably satisfactory for valuing most individual investors' holdings, they often have little or no bearing on the market value of a large holding. Moreover, the factors that determine the "market quotation," I am beginning to believe, are coming to have less and less to do with the values that should be used in preparing sets of financial statements. If your proposal (as to replacement cost) is utilized with respect to the component units of even a modest-sized inventory, the problem of identification of a market or replacement price becomes enormous. As to fixed assets, we need only consider the variety of "appraisals" that can be obtained on request. Moreover, to me there is a vast difference between using a price quotation as a means of estimating a loss and using the same quotation as a means of recognizing a profit to be reflected in the accounts. The latter requires a far higher degree of exactness and objectivity than the former.

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I also do not understand your philosophy in saying that replacement cost is still a cost method. I would not agree with this when it is higher than acquisition cost.

Widespread use of implied interest rates to discount amounts receivable or payable in the future, in my opinion, is neither feasible nor desirable. I recognize that this principle has been used, at times rather frequently, in certain types of accounting calculations. The extension of its use into areas where there is no agreed-upon interest rate involves a considerable area of problem. In view of normal fluctuations of earnings between years, I do not believe there is any "in-

terest rate" that can be identified as the rate which a given company is apt to earn, such rate to be applied on the assumption that this is how useful the delay in payment is to the company. Nor am I very happy about arbitrarily using the prime rate, or some arbitrarily determined higher rate.

I am interested to note that at page 40 you indicate that no adjustment need be made should the interest rate change. Granted that a change can be identified, it would seem to me no more difficult and no less important to apply than the concepts which you developed as to holding gains.

82 Conceptually, your treatment of the correction of errors is probably sound. However, it has certain major drawbacks in practice. For one thing, we all know that short-period calculations of earnings necessarily involve a great deal of judgment and many estimates. If these are biased in one direction or the other, then under your proposal the corrections are passed through surplus rather than income, and the income statements necessarily have a long-term overstatement or understatement. If there is no bias or conscious prejudice, I think a very good argument can be made that errors discovered in a given period should find reflection in that period's income statement except in highly unusual situations. It might even be desirable to show them separately on the theory that in a broad general way they may help to measure the amount of errors probably inherent in the current figures. In all events, I think you should point out that if the corrective entry is really material, it should preferably result in a restatement of the previous years' figures for comparison with the current year, particularly if the error affects primarily the next previous year.

In conclusion, it seems to me that your study largely reflects what is currently understood to be generally accepted accounting principles with two major exceptions—(1) the very broad and general proposal to use market values in place of cost on the balance sheet and in the income statement, including therein both specific price changes and price-level changes, and (2) a very broad utilization of the interest factor in discounting amounts receivable or payable in the future. I again emphasize that if the study is to be published (which I hope it will not in its present form), these two major changes, at least, should be described early in the study so that the reader will be forewarned as to the proposals that you are making rather than to have to read the whole document to come upon them.

Comments of John H. Zebley, Jr.

This study contributes very little to establishing a foundation which may be used by the profession in narrowing the differences of opinion that exist in practice as to what constitutes “generally accepted accounting principles” and, in my opinion, will need to be supplemented and explained by further studies before the goal set by the special committee begins to come into view.

Selected Bibliography

(The items listed below were selected primarily for their relevance to this research project. No attempt has been made to trace ideas to their sources or to compile a definitive bibliography on accounting postulates and principles. General reference works, including textbooks and manuals, have been omitted.)

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